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Audit and Accounting Manual
As of June 1, 2011

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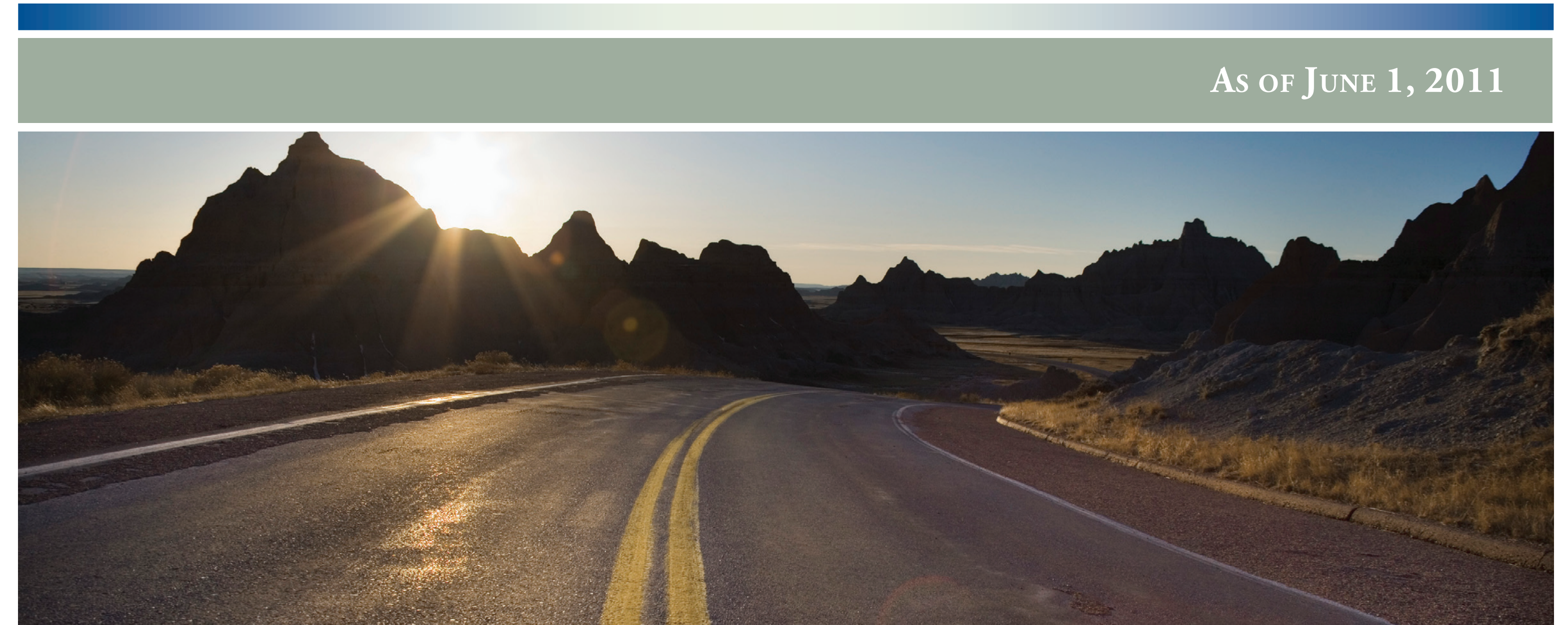
Audit and Accounting Manual

As of June 1, 2011



AICPA

NONAUTHORITATIVE PRACTICE AID

Audit and Accounting Manual

As of June 1, 2011

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How *Audit and Accounting Manual* is Organized

Scope of *Audit and Accounting Manual*

This publication brings together for continuing reference a set of nonauthoritative audit tools and illustrations prepared by the AICPA staff.

Arrangement of Material in *Audit and Accounting Manual*

The material in *Audit and Accounting Manual* is arranged as follows:

Introduction

Engagement Planning and Administration

Internal Control

Designing and Performing Further Audit Procedures

Audit Documentation

Correspondence, Confirmations, and Representations

Alerts

Accountants' Reports

Quality Control

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AAM Section 1000
Introduction

The AICPA *Audit and Accounting Manual* has not been approved, disapproved, or otherwise acted upon by any senior technical committees of the AICPA or the Financial Accounting Standards Board and has no official or authoritative status.

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AAM Section 1100

Introduction

.01 *Audit and Accounting Manual* has been prepared by the staff of the AICPA and issued as a nonauthoritative practice aid. The materials included in it are intended primarily as a reference source for conducting audit, review, and compilation engagements. The objective is to provide practitioners with the tools needed to help plan, perform, and report on their engagements. *The manual is not intended to serve as a complete or comprehensive quality control system.*

.02 The manual, where practicable, offers choices and alternatives rather than particular positions. The use of this or any other practice aid requires the exercise of individual professional judgment. 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.

.03 References are made throughout the manual to original authoritative pronouncements and to their section numbers in AICPA *Professional Standards* to help users locate those authoritative pronouncements. In citing generally accepted auditing standards (GAAS) and their related interpretations, references use section numbers within the codification of currently effective Statements on Auditing Standards (SASs) and not the original statement number, as appropriate. For example, SAS No. 54, *Illegal Acts by Clients*, is referred to as AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*). Similarly, when citing attestation standards, and their related interpretations, references use section numbers within the codification of currently effective Statements on Standards for Attestation Engagements (SSAEs) and not the original statement number, as appropriate.

.04 This manual is intended to be used in connection with engagements of nonpublic entities and is not intended to be used in connection with audits of public entities that are required to be audited under standards set by the Public Company Accounting Oversight Board.

.05 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.

.06

Explanation of References

AT =	Reference to section number in AICPA *Professional Standards* for Statements on Standards for Attestation Engagements
AU =	Reference to section number in AICPA *Professional Standards* for Statements on Auditing Standards
AUD =	Reference to section number in the Auditing and Attestation Statements of Position in AICPA *Technical Practice Aids*
ET =	Reference to section number in AICPA *Professional Standards* for the Code of Professional Conduct, Interpretations of Rules of Conduct, and Ethics Rulings
FASB ASC =	Reference to the Financial Accounting Standards Board *Accounting Standards Codification™*
GAAP =	Generally accepted accounting principles

(continued)

Explanation of References

QC =	Reference to section number in AICPA *Professional Standards* for Statements on Quality Control Standards
SAS =	AICPA Statement on Auditing Standards
SOP =	AICPA Auditing and Attestation Statement of Position
SQCS =	AICPA Statement on Quality Control Standards
SSAE =	AICPA Statement on Standards for Attestation Engagements
SSARS =	AICPA Statement on Standards for Accounting and Review Services

Guidance Considered in This Edition

.07 This edition of the manual has been modified by the AICPA staff to include certain changes necessary due to the issuance of authoritative pronouncements since the last edition of the manual. Relevant guidance contained in official pronouncements issued through June 1, 2011, has been considered in the development of this edition of the manual. Authoritative guidance discussed in the text of the manual (as differentiated from the temporary footnotes, which are denoted by a symbol rather than a number) is effective for entities with fiscal years ending on or before June 1, 2011. Authoritative guidance discussed only in temporary footnotes is not yet effective as of June 1, 2011, for entities with fiscal years ending after that same date. This includes relevant guidance issued up to and including the following:

- SAS No. 121, *Revised Applicability of Statement on Auditing Standards No. 100,* Interim Financial Information (AICPA, *Professional Standards*, AU sec. 722 par. .05)
- Interpretation No. 19, "Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .93–.97)
- Revised interpretations issued through June 1, 2011, including Interpretation Nos. 1–4 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, AU sec. 9325 par. .01–.13)
- SSAE No. 17, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence is Impaired* (AICPA, *Professional Standards*, AT sec. 301 par. .23)
- Interpretation No. 1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of its Financial Statements* (AICPA, *Professional Standards*, AT sec. 9501 par. .01–.07)
- Statement on Quality Control Standards No. 8, *A Firm's System of Quality Control* (Redrafted) (AICPA, *Professional Standards*, QC sec. 10)

Users of this manual should consider guidance issued subsequent to those items in the preceding list to determine its effect on entities covered by this manual. In determining the applicability of a pronouncement, its effective date should also be considered.

FASB *Accounting Standards Codification*™

.08 The accounting guidance in this manual, where such guidance exists, has been conformed to reflect reference to FASB ASC as it existed on June 1, 2011 (through FASB Accounting Standards Update No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*).

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New AICPA.org Website

.09 The AICPA encourages you to visit its new website at www.aicpa.org. It was launched in 2010 and provides significantly enhanced functionality and content critical to the success of AICPA members and other constituents. Certain content on the AICPA's website referenced in this guide may be restricted to AICPA members only.

Auditing Standards Board's Clarity Project

.10 In an effort to make U.S. GAAS easier to read, understand, and apply, the Auditing Standards Board (ASB) launched the Clarity Project. The majority of the clarified auditing standards will be issued as one SAS. Once finalized, the new clarity standards will supersede all prior SASs. The new clarity auditing standards are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established.

.11 The foundation of the ASB's Clarity Project is the establishment of an objective for each auditing standard. These objectives will better reflect a principles-based approach to standard setting. In addition to having objectives, the clarified standards will reflect new drafting conventions that include the following:

- Adding a definitions section, if relevant, in each standard
- Separating requirements from application and other explanatory materials
- Numbering application and other explanatory material paragraphs using an *A-* prefix and presenting them in a separate section (following the requirements section)
- Using formatting techniques, such as bulleted lists, to enhance readability
- Adding special considerations relevant to audits of smaller, less complex entities
- Adding special considerations relevant to audits of governmental entities

.12 The project also has an international convergence component. The ASB expects that, upon completion of the project, the requirements of U.S. GAAS will be converged with those of the International Auditing and Assurance Standards Board. AICPA Audit and Accounting Guides, as well as other AICPA publications, will be conformed to reflect the new standards resulting from the Clarity Project after issuance and as appropriate, based on the effective dates.

.13 This manual is expected to be updated periodically. Changes will likely arise from three main sources:

a. Comments and suggestions from practitioners. Because this manual is a product of AICPA staff and 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.

b. Issuance of new official pronouncements.

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

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AAM Section 1200

How to Use the Audit and Accounting Manual

Overview

.01 *Audit and Accounting Manual* is designed to provide practitioners with the tools needed to help plan, perform, and report on audit engagements. *This manual is not intended to serve as a complete or comprehensive quality control system, and it is not intended to be used in connection with the audits of entities that are required to be audited under standards set by the Public Company Accounting Oversight Board.* This manual comprises the following sections.

Section No.	*Section Name*
1000	Introduction
3000	Engagement Planning and Administration
4000	Internal Control
5000	Designing and Performing Further Audit Procedures
6000	Audit Documentation
7000	Correspondence, Confirmations, and Representations
8000	Alerts
9000	Accountants' Reports
10,000	Quality Control

Audits

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

.03 The General Standards are concerned with the qualifications of the auditor and the qualitative aspects 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. Each 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 This manual will assist the auditor in performing an audit, in accordance with GAAS, in the following ways:

a. Section 10,000, *Quality Control*, includes sample forms that can be used by a firm to document its adherence to the AICPA requirement for a system of quality control for a CPA firm.

b. Section 3000, *Engagement Planning and Administration*, provides guidance in the planning stage. Included in this section are various formats of audit assignment controls and engagement letters.

c. Section 4000, *Internal Control*, conforms to *Internal Control—Integrated Framework,* published by the Committee of Sponsoring Organizations of the Treadway Commission, and AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). This section provides guidance on evaluating internal control by utilizing checklists, questionnaires, and other generalized aids.

d. Section 5000, *Designing and Performing Further Audit Procedures*, explains how the auditor should design and perform tests of controls, substantive procedures, or both, that are responsive to the assessed risks of material misstatement.

e. Section 6000, *Audit Documentation*, provides the auditor with a general discussion of the purpose of audit documentation.

f. Section 7000, *Correspondence, Confirmations, and Representations*, provides the auditor with numerous examples of confirmations, illustrative inquiries to legal counsel, representation letters, communications with audit committees, and a reliance letter.

g. Section 9000, *Accountants' Reports*, addresses the format of the accountant's report and provides numerous examples of the auditor's report.

Alerts

.07 Section 8000, *Alerts*, is intended to provide practitioners with an overview of recent economic, professional, and regulatory developments that may affect their engagements.

[*The next page is 2001.*]

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AAM Section 2000
Compilation and Review

Effective January 1, 2011, the compilation and review material that historically has been included in this section was removed.

For accountants performing compilation and review engagements on financial statements for periods ending on or after December 15, 2010, the AICPA has developed the guide *Compilation and Review Engagements*. The guide was released in 2010 and provides additional information on implementing Statement on Standards for Accounting and Review Services (SSARS) No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*), and understanding internal control services. It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. The guide is available at www.cpa2biz.com (enter product code 0128111 for further information). This guide is also available as an online package along with the annual *Compilation and Review Developments* alert (product code WRC-XX). The most recent *Compilation and Review Developments* alert has been included in this manual and can be found in section 8015.

The AICPA has a site dedicated to the most recent compilation and review developments, as well as further information on the Accounting and Review Services Committee. Learn more at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/CompReview/Pages/CompilationandReviewServices.aspx.

In addition, the AICPA has a site with resources for SSARS No. 19, including white papers related to SSARS No. 19, a summary of SSARS No. 19, and an article from the May 2010 *Journal of Accountancy* that discusses the changes to compilation and review standards because of SSARS No. 19. These resources can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/CompReview/CompRevStds/Pages/ResourcesforSSARSNo19.aspx.

[*The next page is 3001.*]

AAM Section 3000 Engagement Planning and Administration

Sections 3160 and 3165 include illustrative audit assignment control forms and engagement letters that can be used by an accountant in the planning phase of an audit engagement.

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

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

Readers should consider other sources of illustrative presentations, such as those in authoritative pronouncements and AICPA Audit and Accounting Guides.

References to Professional Standards. When referring to the professional standards, this manual cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards No. 54, *Illegal Acts by Clients*, is referred to as AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*).

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AAM Section 3100

Planning the Engagement

General

.01 The planning phase is an important part of every engagement. During this phase, the partner and the staff obtain an understanding of the entity and its environment, including its internal control, then develop an overall strategy for the expected conduct and scope of the engagement.

.02 The need for planning is highlighted in Rule 201, *General Standards* (AICPA, *Professional Standards*, ET sec. 201 par. .01), of the AICPA Code of Professional Conduct, which states that a member shall adequately plan and supervise the performance of professional services.

.03 The first standard of fieldwork of generally accepted auditing standards (GAAS) states that the auditor must adequately plan the work and must properly supervise any assistants. AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), establishes standards and provides guidance to the independent auditor conducting an audit in accordance with GAAS on the considerations and activities applicable to planning and supervision.

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

.05 The nature, timing, and extent of planning vary with the size and complexity of the entity and with the auditor's experience with the entity and understanding of the entity and its environment, including its internal control. The auditor must plan the audit so that it is responsive to the assessment of the risks of material misstatement based on the auditor's understanding of the entity and its environment, including its internal control (see sections 3120 and 3125).

Audit Planning

.06 Planning is not a discrete phase of the audit, but rather an iterative process that begins with engagement acceptance and continues throughout the audit as the auditor performs audit procedures and accumulates sufficient appropriate audit evidence to support the audit opinion. As a result of performing planned audit procedures,[1] the auditor may obtain disconfirming evidence that might cause the auditor to revise the overall audit strategy. Any modification to the initial audit strategy should be documented. An audit strategy developed before the auditor obtains an understanding of the business and the risks of material misstatement may require updating, or a whole new strategy.

Appointment of the Independent Auditor

.07 Early appointment of the independent auditor has many advantages to both the auditor and the client. Early appointment enables the auditor to plan the audit prior to the balance-sheet date. Although early appointment is preferable, an independent auditor may accept an engagement near or after the close of the fiscal year. In such instances, before accepting the engagement, the auditor should ascertain whether circumstances are likely to permit an adequate audit and expression of an unqualified opinion and, if they

[1] Paragraph .03 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), provides guidance with respect to the procedures the auditor performs in obtaining an understanding of the entity and its environment to establish a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing the risks of material misstatement of the financial statements.

will not, the auditor should discuss with the client the possible necessity for a qualified opinion or disclaimer of opinion.

Forming an Audit Strategy

.08 In establishing the overall audit strategy, the auditor should (1) determine the characteristics of the engagement that define its scope, such as the basis of reporting, industry specific reporting requirements, and the locations of the entity; (2) ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as deadlines for interim and final reporting, and key dates for expected communications with management and those charged with governance; and (3) consider the important factors that will determine the focus of the audit team's efforts, such as determination of appropriate materiality levels, preliminary identification of areas where there may be higher risks of material misstatement, preliminary identification of material locations and account balances, evaluation of whether the auditor may plan to obtain evidence regarding the operating effectiveness of internal control, and identification of recent significant entity specific, industry, financial reporting, or other relevant developments. The appendix to AU section 311 provides examples of matters the auditor may consider in establishing the overall audit strategy.

The Audit Plan

.09 The auditor must develop an audit plan in which the auditor documents the audit procedures to be used that, when performed, are expected to reduce audit risk to an acceptably low level. The audit plan is more detailed than the audit strategy and includes the nature, timing, and extent of audit procedures to be performed by audit team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Documentation of the audit plan also serves as a record of the proper planning and performance of the audit procedures that can be reviewed and approved prior to the performance of further audit procedures. The audit plan should include the following:

- A description of the nature, timing, and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement, as determined under AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*). Because these procedures normally are the first procedures performed by the auditor to gather audit evidence to support the audit opinion, the auditor typically plans the risk assessment procedures first, or early in the audit.
- A description of the nature, timing, and extent of planned further audit procedures at the relevant assertion level for each material class of transactions, account balance, and disclosure, as determined under AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*). The plan for further audit procedures reflects the auditor's decision whether to test the operating effectiveness of controls and the nature, timing, and extent of planned substantive procedures. Because the design of further audit procedures depends on the results of the auditor's assessment of the risks of material misstatement, the auditor typically will not develop the plan for further audit procedures until the auditor has completed the risk assessment procedures.
- A description of other audit procedures to be carried out for the engagement in order to comply with GAAS (for example, seeking direct communication with the entity's lawyers). The auditor's plan for these procedures evolves over the course of the audit as audit evidence is obtained.

Establishing an Understanding With the Client and Preparing an Engagement Letter

.10 The auditor should establish an understanding with the client regarding the services to be performed for each engagement. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and limitations of the engagement. Such an understanding reduces the risk that either the auditor or the client may misinterpret the needs or expectations of the other

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party. The understanding could also include matters such as the timing of field work, report deadlines, and methods of fee determination and payment.

.11 AU section 311 states that the auditor should document the understanding through a written communication with the client in the form of an engagement letter. An engagement letter helps to prevent misunderstandings between the client and the auditor regarding the services to be provided, including the limitations. The engagement letter also sets forth the responsibilities of the client and, in most states, it becomes a legally binding contract on both parties. There are other good reasons to obtain an engagement letter, including the following:

- *Reduce the risk of litigation and avoid misunderstandings with the client*. In today's litigious environment an engagement letter is needed for both old and new clients. To avoid misunderstandings, the engagement letter generally describes 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 auditor and the client.
- *Avoid misunderstandings by the staff*. It is necessary for the members of the staff working on the engagement to have a complete understanding of what is required of them. A copy of the engagement letter in the working papers provides them with an authoritative reference to supplement their oral instructions.

.12 Often, entities that have never been audited resist signing a client representation letter. To avoid client resistance at the end of the audit, many firms notify the client in the engagement letter that they will be asked to sign a client representation letter.

.13 If the auditor has reason to believe the client may publish all or a portion of an audit report, he may 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 protects both the client and the auditor 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.

.14 Generally, the auditor establishes the understanding with the client and prepares the engagement letter before any significant work takes place on the engagement. The partner may personally present the letter to the client to ensure that a complete understanding has been achieved. The understanding or a signed copy of the engagement letter may be filed with the engagement's current working papers and permanent file.

Practice Tip

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

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

Special Considerations

.16 The following matters may be considered while preparing an engagement letter:

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

  - The auditor is retained after the beginning of the client's fiscal year, did not observe inventories or confirm receivables at the beginning of the year and was unable to gain satisfaction through application of alternative procedures.
  - The client imposes restrictions on the scope of the audit. (AU section 508, *Reports on Audited Financial Statements* [AICPA, *Professional Standards*]).
  - Significant litigation or other matters exist which may affect the opinion.
- Whether the fee should be stated as a range, in hourly rates, as standard per diem charges for the engagement, or as a maximum or flat fee
- The person or persons to whom reports should be addressed
- The number of copies needed of the report and the people to whom they are to be distributed
- Deadlines for reports or analyses
- Out-of-pocket costs
- Additional work not contemplated in the original engagement
- The condition of records or circumstances other than those contemplated in the engagement letter (for example, deficient internal control)
- A retainer
- One time engagements
- Start up costs when the client changes auditors
- Underwriters' requirements in connection with public offerings
- The part of the work to be done by other auditors

Fee Issues

.17 Two types of fee arrangements, contingent fees and commissions, are prohibited when the arrangement involves certain attest clients (see paragraph .36 following in this section of the manual for details), even though the fee is not related to an attest service.

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

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

The following are exceptions:

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

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

.20 Examples of commissions are if you or your firm

- refers a client to a financial planning firm that pays you a commission for the referral.

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- sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company.
- refers a nonclient to an insurance company client, which pays you a percentage of any premiums subsequently received (a commission) from the nonclient.

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

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

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

.23 You and your firm may have commission and contingent fee arrangements with persons associated with a client—such as officers, directors, and principal shareholders—or with a benefit plan that is sponsored by a client (that is, the plan itself is not a client).[2] For example, you or your firm may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer and the officer purchases a policy. Even when permitted, the existence of a commission arrangement must be disclosed to the person (or entity) to whom the commission relates.

Contents of Engagement Letters

.24 An understanding with the client and an engagement letter regarding an audit of the financial statements generally includes the following matters:

- The objective of the audit is the expression of an opinion on the financial statements.
- Management is responsible for the entity's financial statements and the selection and application of the accounting policies.
- Management is responsible for establishing and maintaining effective internal control over financial reporting.
- Management is responsible for designing and implementing programs and controls to prevent and detect fraud.
- Management is responsible for identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
- Management is responsible for making all financial records and related information available to the auditor.
- At the conclusion of the engagement, management will provide the auditor with a letter that confirms certain representations made during the audit.
- The auditor is responsible for conducting the audit in accordance with GAAS. Those standards require that the auditor obtain reasonable rather than absolute assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Accordingly, a

[2] Also see AICPA Ethics Ruling No. 25, "Commission and Contingent Fee Arrangements With Nonattest Client," of ET section 391, *Ethics Rulings on Responsibilities to Clients* (AICPA, *Professional Standards*, ET sec. 391 par. .049–.050), of the Code of Professional Conduct.

material misstatement may remain undetected. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. If, for any reason, the auditor is unable to complete the audit or is unable to form or has not formed an opinion, he or she may decline to express an opinion or decline to issue a report as a result of the engagement.

- An audit includes obtaining an understanding of the entity and its environment, including its internal control, sufficient to assess the risks of material misstatement of the financial statements and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify significant deficiencies. However, the auditor is responsible for ensuring that those charged with governance are aware of any significant deficiencies that come to his or her attention.
- Management is responsible for adjusting the financial statements to correct material misstatements and for affirming to the auditor in the representation letter that the effects of any uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

.25 The engagement letter is generally addressed to those charged with governance, the chief executive, or whoever retained the firm. If the engagement letter also serves as the method of communicating the auditor's responsibilities under AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), the addressee should include those persons charged with governance. See further discussion in paragraph .29 in this section of this manual. The engagement partner may sign the letter on behalf of the firm. The client representative responsible for the engagement signs the letter denoting agreement with the contract. The original letter may be maintained in the engagement documentation. A copy of the letter is given to the client.

.26 An understanding with the client and an engagement letter may include other matters, such as the following:

- The overall audit strategy.
- Involvement of specialists or internal auditors, if applicable.
- Involvement of a predecessor auditor.
- Fees and billing. Estimates of fees are usually based on conservative, carefully prepared estimates. It may be useful to describe the expected billing methods and payment periods.
- Any limitation of or other arrangements regarding the liability of the auditor or the client, such as indemnification to the auditor for liability arising from knowing misrepresentations to the auditor by management (regulators, such as the Securities and Exchange Commission, may restrict or prohibit such liability limitation arrangements).
- Conditions under which access to the auditor's documentation may be granted to others.
- Additional services to be provided relating to regulatory requirements.
- Other services to be provided in connection with the engagement, for example, nonattest services, such as accounting assistance and preparation of tax returns subject to the limitations of Interpretation No. 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05).

.27 The client assistance schedule is usually tailored to each specific engagement. The following is a list of analyses, schedules and other items that are often requested from the client prior to the start of an audit engagement:

- The general ledger.
- A reconciliation for each bank account.
- A trade accounts receivable aging.

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

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

- Reference in the letter to audit of the books and records rather than to audit of financial statements
- Adverse comments about other firms
- Failure to specify *in detail* the services to be rendered when a maximum fee is quoted
- Inclusion of a review of internal control as one of the services when what is really intended is an understanding of internal control as required by auditing standards
- Failure to identify accounting or other problems that may have an effect on the opinion
- Failure to change, in writing, the terms of the engagement when conditions are found to be different (such as the inability to express an opinion without extensive additional auditing because internal control was found deficient)
- Failure to include fee basis and payment terms
- Failure to identify subsidiaries

- Failure to identify specific tax returns to be prepared
- Failure to document the scope of the engagement

Investigatory Procedures for Individuals

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

.30 Under the Fair Credit Reporting Act, an individual is 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 is also advised, within three days of the time the report is requested, that he or she may, within a reasonable time, by written request, be furnished disclosure of the nature and scope of the investigation.

Sample Engagement Letters

.31 See section 3165, "Sample Engagement Letters," for sample engagement letters.

Preliminary Engagement Activities

.32 In addition to the procedures mentioned previously, at the beginning of the audit engagement the auditor should (1) perform procedures regarding the continuance of the client relationship and the specific audit engagement and (2) evaluate the auditor's compliance with ethical requirements, including independence. The purpose of performing these preliminary engagement activities is to consider any events or circumstances that may either adversely affect the auditor's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level or may pose an unacceptable level of risk to the auditor.

Determining the Extent of Involvement of Professionals Possessing Specialized Skills

.33 The auditor should consider whether specialized skills are needed in performing the audit. If specialized skills are needed, the auditor should seek the assistance of a professional possessing such skills, who may be either on the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should determine whether that professional will effectively function as a member of the audit team. If such a professional is part of the audit team, the auditor's responsibilities for supervising that professional are equivalent to those for other assistants. In such circumstances, the auditor should have sufficient knowledge to communicate the objectives of the other professional's work; to evaluate whether the specified audit procedures will meet the auditor's objectives; and to evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures.

.34 The use of professionals possessing IT skills to determine the effect of IT on the audit, to understand the IT controls, or to design and perform tests of IT controls or substantive procedures is a significant aspect of many audit engagements. In determining whether such a professional is needed on the audit team, the auditor should consider such factors as the following:

- The complexity of the entity's systems and IT controls and the manner in which they are used in conducting the entity's business
- The significance of changes made to existing systems, or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the entity's participation in electronic commerce
- The entity's use of emerging technologies
- The significance of audit evidence that is available only in electronic form

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.35 Audit procedures that the auditor may assign to a professional possessing IT skills include inquiring of an entity's IT personnel how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed; inspecting systems documentation; observing the operation of IT controls; and planning and performing tests of IT controls.

Communications With Those Charged With Governance and Management

.36 Paragraph .23 of AU section 380 explains that, among other matters, the auditor should communicate with those charged with governance (1) the auditor's responsibilities under GAAS and (2) an overview of the planned scope and timing of the audit.

Additional Considerations in Initial Audit Engagements

.37 Before starting an initial audit, the auditor should perform procedures regarding the acceptance of the client relationship and the specific audit engagement (see Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* [AICPA, *Professional Standards*, QC sec. 10A])[3] and communicate with the previous auditor, where there has been a change of auditors (see AU section 315, *Communication Between Predecessor and Successor Auditors* [AICPA, *Professional Standards*]). The purpose and objective of planning the audit are the same whether the audit is an initial or recurring engagement. However, for an initial audit, the auditor may need to expand the planning activities because the auditor does not have the previous experience with the entity that is considered when planning recurring engagements. Paragraph .27 of AU section 311 provides additional matters the auditor should consider in developing the overall audit strategy and audit plan for an initial audit.

[*The next page is 3121.*]

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[3] Refer to section 10,000, "Quality Control," for additional discussion of Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), and establishing and maintaining a firm's system of quality control.

AAM Section 3105

Understanding the Assignment

.01 The auditor may (*a*) meet with the client to understand the type, scope, and timing of the engagement; (*b*) understand if reports on compliance, internal control, or segments of the entity are required; (*c*) understand the client's expectations, both stated and implied; and (*d*) review the expectations of both the owners and managers.

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

Financial Accounting Standards Board *Accounting Standards Codification*™

Overview

.03 Released on July 1, 2009, the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) is a major restructuring of accounting and reporting standards designed to simplify user access to all authoritative U.S. GAAP by topically organizing the authoritative literature. FASB ASC disassembled and reassembled thousands of nongovernmental accounting pronouncements (including those of FASB, the EITF, and the AICPA) to organize them under approximately 90 topics.

.04 FASB ASC also includes relevant portions of authoritative content issued by the Securities and Exchange Commission (SEC), as well as selected SEC staff interpretations and administrative guidance issued by the SEC; however, FASB ASC is not the official source of SEC guidance and does not contain the entire population of SEC rules, regulations, interpretive releases, and SEC staff guidance. Moreover, FASB ASC does not include governmental accounting standards.

.05 FASB published a notice to constituents that explains the scope, structure, and usage of consistent terminology of FASB ASC. Constituents are encouraged to read this notice to constituents because it answers many common questions about FASB ASC. FASB ASC, and its related notice to constituents, can be accessed at http://asc.fasb.org/home and are also offered by certain third party licensees, including the AICPA. FASB ASC is offered by FASB at no charge in a Basic View and for an annual fee in a Professional View.

FASB Statement No. 168

.06 In June 2009, FASB issued the last FASB statement referenced in that form: FASB Statement No. 168, *The FASB* Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*. This standard establishes FASB ASC as the authoritative source of U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC, and is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

.07 This standard flattened the historic U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992.

Generally Accepted Auditing Standards

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

.09 AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), provides a framework of GAAS.

.10 The general, field work, and reporting standards (the 10 standards) are as follows:

General Standards

a. The auditor must have adequate technical training and proficiency to perform the audit.

b. The auditor must maintain independence in mental attitude in all matters relating to the audit.

c. The auditor must exercise due professional care in the performance of the audit and the preparation of the report.

Standards of Fieldwork

a. The auditor must adequately plan the work and must properly supervise any assistants.

b. The auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

c. The auditor must obtain sufficient appropriate[1] audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit.

Standards of Reporting[2]

a. The auditor must state in the auditor's report whether the financial statements are presented in accordance with GAAP.[3]

b. The auditor must identify in the auditor's report those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.

c. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

d. The auditor must either express an opinion regarding the financial statements, taken as a whole, or state that an opinion cannot be expressed, in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking, in the auditor's report.

.11 Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), of the AICPA Code of Professional Conduct requires an AICPA member who performs an audit (the auditor) to comply with standards promulgated by the Auditing Standards Board (ASB). The ASB develops and issues standards in

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[1] See paragraph .06 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), for the definition of the term *appropriate*.

[2] The reporting standards apply only when the auditor issues a report.

[3] When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, the first standard of reporting is satisfied by stating in the auditor's report that the basis of presentation is a comprehensive basis of accounting other than generally accepted accounting principles and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used.

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the form of Statements on Auditing Standards (SASs) through a due process that includes deliberation in meetings open to the public, public exposure of proposed SASs, and a formal vote. The SASs are codified within the framework of the 10 standards.

.12 The nature of the 10 standards and the SASs requires the auditor to exercise professional judgment in applying them. Materiality and audit risk also underlie the application of the 10 standards and the SASs, particularly those related to field work and reporting.[4] The auditor should be prepared to justify departures from the SASs. When, in rare circumstances, the auditor departs from a presumptively mandatory requirement, the auditor must document in the working papers his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.

.13 *Interpretive publications* consist of auditing interpretations of the SASs, appendixes to the SASs,[5] auditing guidance included in AICPA Audit and Accounting Guides, and AICPA auditing Statements of Position.[6] Interpretive publications are not auditing standards. Interpretive publications are recommendations on the application of the SASs in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the ASB after all ASB members have been provided an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the SASs.

.14 The auditor should be aware of and consider interpretive publications applicable to his or her audit. If the auditor does not apply the auditing guidance included in an applicable interpretive publication, the auditor should be prepared to explain how he complied with the SAS provisions addressed by such auditing guidance.

.15 *Other auditing publications* include the following:

- AICPA auditing publications not referred to previously
- Auditing articles in the *Journal of Accountancy* and other professional journals
- Auditing articles in the AICPA *CPA Letter*
- Continuing professional education programs and other instructional materials, textbooks, guide books, audit programs and checklists; and other auditing publications from state CPA societies, other organizations and individuals.[7]

Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the SASs.

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[4] See AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*).

[5] Appendixes to the Statements on Auditing Standards (SASs) referred to in paragraph .05 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*), do not include previously issued appendixes to original pronouncements that when adopted modified other SASs.

[6] Auditing interpretations of the SASs are included in the codified version of the SASs. AICPA Audit and Accounting Guides and auditing Statements of Position are listed in AU appendix D, "AICPA Audit and Accounting Guides and Statements of Position" (AICPA, *Professional Standards*).

[7] The auditor is not expected to be aware of the full body of other auditing publications.

.16 If an auditor applies the auditing guidance included in an other auditing publication, he should be satisfied that, in his judgment, it is both relevant to the circumstances of the audit, and appropriate. In determining whether an other auditing publication is appropriate, the auditor may wish to consider the degree to which the publication is recognized as being helpful in understanding and applying the SASs and the degree to which the issuer or author is recognized as an authority in auditing matters. Other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff are presumed to be appropriate.[8]

[*The next page is 3141.*]

[8] Other auditing publications published by the AICPA that have been reviewed by the AICPA Audit and Attest Standards staff as listed in AU appendix F, "Other Auditing Publications" (AICPA, *Professional Standards*).

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AAM Section 3110

Assigning Personnel to the Engagement and Supervision

General Comments

.01 Engagement planning includes procedures for assigning personnel to the engagement. Having procedures established provides 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 guidance for assigning personnel to engagements is addressed in the practice aid *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (product no. 006636), and in "A Firm's System of Quality Control" in section 10,200. Sample quality control forms are available at section 10,300, which are helpful in assigning personnel to engagements.

Engagement Planning Procedures

.03 A time budget for the engagement is prepared to determine manpower requirements and to schedule field work. The engagement partner may approve the time budget prior to the beginning of field work. A time budget may 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 paragraph .01 of section 3160 for "Audit Time Budget—Sample A"), whereas others combine these reports into one form (see paragraph .02 of section 3160 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, 100 hours; see paragraph .03 of section 3160 for "Audit Time Analysis—Short Form") and a longer form for jobs requiring more time (see paragraph .04 of section 3160 for "Audit Time Analysis—Long Form"). Some firms use a weekly (or daily) progress report (see paragraph .05 of section 3160, for example). This report, submitted by the auditor 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 is kept current as the assignment progresses. This form is carried in the working papers file and is filled in daily by the auditor in charge for all persons applying time on the engagement. This procedure is vital to identify and control time because it is applied so that it can be compared to the budgeted time for that phase of the engagement.

.06 The following factors may 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 is 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 is 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 the auditor document all procedures discussed in this section in the auditor's working papers.

Supervision

.09 Supervision involves directing the efforts of assistants who are involved in accomplishing the objectives of the audit and determining whether those objectives were accomplished. Elements of supervision include instructing assistants, keeping informed of significant issues encountered, reviewing the work performed, and dealing with differences of opinion among firm personnel. The extent of supervision appropriate in a given instance depends on many factors, including the complexity of the subject matter and the qualifications of persons performing the work, including knowledge of the client's business and industry.

.10 The auditor with final responsibility for the audit should communicate with members of the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, with special emphasis on fraud. Such discussion helps all audit team members understand the entity and its environment, including its internal control, and how risks that the entity faces may affect the audit. The discussion should emphasize the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating evidence throughout the audit.[1]

.11 In addition, assistants should be informed of their responsibilities and the objectives of the audit procedures they are to perform. They should be informed of matters that may affect the nature, timing, and extent of audit procedures they are to perform, such as the nature of the entity's business as it relates to their assignments and possible accounting and auditing issues. The auditor with final responsibility for the audit should direct assistants to bring to his or her attention accounting and auditing issues raised during the audit that the assistant believes are of significance to the financial statements or auditor's report so the auditor with final responsibility may assess their significance. Assistants also should be directed to bring to the attention of appropriate individuals in the firm difficulties encountered in performing the audit, such as missing documents or resistance from client personnel in providing access to information or in responding to inquiries.

.12 The work performed by each assistant, including the audit documentation, should be reviewed to determine whether it was adequately performed and documented and to evaluate the results, relative to the conclusions to be presented in the auditor's report.

[1] For further guidance on the discussion among the audit team, see paragraphs .14–.18 of AU section 316, *Consideration of Fraud in a Financial Statement Audit*, and paragraphs .14–.20 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*).

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.13 Each assistant has a professional responsibility to bring to the attention of appropriate individuals in the firm disagreements or concerns with respect to accounting and auditing issues that the assistant believes are of significance to the financial statements or auditor's report, however those disagreements or concerns may have arisen. The auditor with final responsibility for the audit and assistants should be aware of the procedures to be followed when differences of opinion concerning accounting and auditing issues exist among firm personnel involved in the audit. Such procedures should enable an assistant to document his or her disagreement with the conclusions reached if, after appropriate consultation, he or she believes it necessary to disassociate himself or herself from the resolution of the matter. In this situation, the basis for the final resolution should also be documented.

[*The next page is 3161.*]

AAM Section 3115

Independence

General Comments

.01 In accordance with Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .01), of the AICPA Code of Professional Conduct, a member in public practice shall be independent in the performance of professional services, as required by standards promulgated by bodies designated by council, which includes but is not limited to attest engagements.[1] Attest engagements are those in which your firm attests—or affirms—that a client's financial or other information is reasonably stated. Examples of attest services are

- financial statement audits,
- financial statement reviews, and
- other attest services as defined in the Statements on Standards for Attestation Engagements.

.02 Third parties—investors, creditors, and others—rely on your firm's attestations about a client's financial information when making various business decisions. Therefore, attest services have value for third parties only if an *independent firm* renders the services. Accordingly, AICPA *Professional Standards* states that the auditor must maintain independence in mental attitude in all matters relating to the audit; therefore, your firm may perform attest services for a client *only* when it is independent of that client. Independence is not required to perform the following services, if these are the *only* services your firm provides to a client:

a. Tax preparation and advice

b. Consulting services (such as tax consulting or personal financial planning)

.03 Engagement planning includes procedures to provide the firm with reasonable assurance that all persons required to maintain independence, to the extent required by the AICPA Code of Professional Conduct and the regulations of other organizations, as applicable (for example, the Securities and Exchange Commission [SEC], and the Department of Labor), do so. The interpretations and rulings under Ethics Rule 101 of the AICPA Code of Professional Conduct contain examples of instances wherein a firm's independence will be considered to be impaired.

.04 As stated in the following text, audit firms that perform audits of or perform other attest services for public companies or other SEC registrants should consult the independence rules of the SEC and the Public Company Accounting Oversight Board (PCAOB).

.05 Other organizations that have established other independence requirements that a member should consult if applicable include the following:

- State boards of accountancy
- State CPA societies
- Federal and state agencies, such as the Governmental Accountability Office (GAO)

.06 Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule. The AICPA's Practice Aids, *Independence Compliance—Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006661), and

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

Independence Compliance: Checklists and Tools for Complying with AICPA, SEC, and PCAOB Independence Requirements (product no. 006660), are valuable resources for helping practitioners observe applicable independence rules. The practice aids can be obtained by searching for the aforementioned product numbers at www.cpa2biz.com or by calling (888) 777-7077.

Maintaining Your Independence[*, 2]

.07 Maintaining your independence is your responsibility, not your firm's. As part of its quality control system, the firm is often required to address independence matters; however, ultimately it is up to you to follow firm policies and the independence rules. Many firms require you to certify your independence on a regular basis. The following are some suggestions that will help you to complete and sign that certification in good faith.

.08 *Gain an understanding of the independence rules and firm policies.* As a prerequisite to establishing and maintaining the independence, a good, working understanding of the basic independence rules is essential. Accordingly, in addition to this brief discussion about independence, CPAs should also consult and understand the AICPA Code of Professional Conduct. It is also important to be aware of the circumstances in which you and your immediate family meet the definition of a covered member (discussed in the following section in greater detail) and of the types of relationships you and your immediate family may have with the firm's clients that could impair independence. If you have any questions about independence matters, you may consult with someone in your firm who is knowledgeable about such matters, or you may seek the advice of the AICPA (ethics@aicpa.org). If your firm performs audits and other attest services for SEC registrants, you should also familiarize yourself with rules promulgated by the SEC and the PCAOB.

Covered Member

.09 Know when you meet the definition of a covered member. Whenever you are a *covered member* with respect to a particular attest client, you become subject to the highest possible level of independence restrictions (for example, restrictions on financial and business interests, and your family's employment). According to paragraph .06 of ET section 92, *Definitions* (AICPA, *Professional Standards*), you are a *covered member* with respect to a client if you are

a. an individual on the attest engagement team;

b. an individual in a position to influence the attest engagement;

c. a partner or manager who provides more than 10 hours of nonattest services to the attest client;

d. a partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;

e. the firm, including the firm's employee benefit plans; or

f. an entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described in (*a*)–(*e*) or by two or more such individuals or entities if they act together.

[*] In July 2010, the AICPA Professional Ethics Executive Committee released Interpretation No. 101-17, "Networks and Network Firms," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .19). Interpretation No. 101-17 established definitions for the terms *network* and *network firm* in paragraphs .21–.22 of ET section 92, *Definitions* (AICPA, *Professional Standards*), respectively, that address practice by accounting firms within certain types of membership associations, that is, networks. Interpretation No. 101-17 specifies that when firms and entities in an association cooperate with each other for the purpose of enhancing their capabilities to provide professional services and when they share certain characteristics, the association is considered to be a network, and the firms and other entities that belong to the network are considered to be network firms and must be independent of certain attest clients of the other network firms. Interpretation No. 101-17 is effective for engagements covering periods beginning on or after July 1, 2011, and may be found at www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_101.aspx#10117.

[2] The staff of the AICPA Professional Ethics Division prepared a plain-English digest of the AICPA independence rules to help you to understand independence requirements under the AICPA Code of Professional Conduct and, if applicable, other rule-making and standard-setting bodies. This digest of the AICPA independence rules is available on the AICPA Professional Ethics Division's website at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/plainenglish.doc.

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.10 However, due to their magnitude, two relationships with a client impair independence even when you are *not* a covered member.

The following rules apply to partners and professional employees of a firm who are not covered members:

- No partner or professional employee may be simultaneously associated with an attest client during the period covered by the financial statements or during the period of the professional engagement as a
  - — director, officer, or employee (or in any capacity equivalent to a member of management),
  - — promoter, underwriter, or voting trustee, or
  - — trustee of any of the client's pension or profit-sharing trust.
- No partner or professional employee, his or her immediate family, or any group of such persons acting together may own more than 5 percent of an attest client's outstanding equity securities (or other ownership interests).

Family Members

.11 The investments and employment of certain family members may impair your independence. Know which of your family members meet the definition of *immediate family* and which ones meet the definition of *close relative* as defined in ET section 92.

.12 If you are a covered member with respect to a client, members of your immediate family (your spouse, spousal equivalent, or dependents [whether related or not]) should follow the same rules as you. So, for example, your spouse's investments should be investments that you could own under the rules. This would be the case even if your spouse keeps the investments in his or her own name or with a different broker.

.13 The following are exceptions to this general rule:

a. Your immediate family member's employment with a client would not impair your firm's independence provided he or she is not in a *key position*. A key position is one in which your immediate family member

  i. has primary responsibility for significant accounting functions that support material components of the financial statements;

  ii. has primary responsibility for preparing the financial statements; or

  iii. has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, CEO, president, CFO, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

b. Immediate family members in permitted employment positions may participate in certain employee benefit plans that are attest clients or are sponsored by an attest client, provided the plan is offered to all employees in comparable positions and the immediate family member does not serve in a position of governance for the plan or have the ability to supervise or participate in the plan's investment decisions or selection of investment options.

c. Immediate family members of *certain* covered members may have a financial interest in a client through an employee benefit plan (for example, retirement or savings account) provided the immediate family member has no other investment options available for selection, and when such option becomes available, the immediate family member selects the option and disposes of any direct or material indirect financial interest in the attest client.

d. Immediate family members in permitted employment positions of certain covered members may participate in share-based compensation arrangements and nonqualified deferred compensation plans provided certain safeguards are implemented.

e. The covered members whose families may invest or participate in the plans described in preceding items *c* and *d* are the following:

i. Partners and managers who are covered members only because they provide nonattest services to the client

ii. Partners who are covered members only because they practice in the same office where the client's lead attest partner practices in connection with the engagement

.14 Also note that at no time may any direct or material indirect financial interests in an attest client permitted by the preceding exceptions exceed 5 percent of the attest client's outstanding equity securities or other ownership interests.

.15 The close relatives of *most* covered members will be subject to some employment and financial restrictions. These covered members are

- persons on the attest engagement team,
- persons who can influence the attest engagement, and
- any partners in the office where the client's lead partner the attest engagement.

.16 Close relatives are your

- nondependent children,
- siblings, or
- parents.

.17 Therefore, as a covered member, your close relative's employment by a client would impair independence if your relative had a key position with the client. However, if you are a covered member who provides only nonattest services to a client, then your close relative's employment by a client in a key position would not impair independence.

.18 Rules pertaining to your close relatives' financial interests differ depending on why you are considered a covered member:

- If you are a covered member because you participate on the client's attest engagement team, your independence would be considered to be impaired if you are aware that your close relative has a financial interest in the client that either
  - — was material to your relative's net worth and of which you have knowledge or
  - — enables the relative to exercise significant influence over the client.
- If you are a covered member because you are able to influence the client's attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that
  - — is material to your relative's net worth and of which you or the partner have knowledge and
  - — enables your relative to exercise significant influence over the client.

Financial Relationships

.19 There are various types of financial interests and some of those interests affect independence. Although your firm and its employee benefit plans are also subject to the financial interest provisions of the independence rules (firms are included in the definition of *covered member*), here we focus on their application to individuals.

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

- direct financial interest in that client, regardless of how immaterial it would be to your net worth.
- material indirect financial interest in that client.

> ***Note:*** The AICPA Code of Professional Conduct does not define or otherwise provide guidance on determining materiality. In determining materiality, you should apply professional judgment to all relevant facts and circumstances and refer to applicable guidance in the professional literature. Both qualitative and quantitative factors should be considered.

.21 In addition, if you commit to acquire a financial interest in a client with respect to which you are a covered member, your independence would be impaired. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

.22 According to Interpretation No. 101-15, "Financial Relationships," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .17), a *financial interest* is an ownership interest in an equity or a debt security issued by an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.

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

.24 Direct financial interests are financial interests that are

- owned by you directly;
- under your control; or
- beneficially owned[3] by you through an investment vehicle, estate, trust, or other intermediary if you can either
  - — control the intermediary, or
  - — have the authority to supervise or participate in the intermediary's investment decisions.

For example, if you invest in a participant directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

.25 You also have a direct financial interest in a client when you have a financial interest in a client through one of the following:

- A partnership, if you are a general partner.
- A Section 529 savings plan, if you are the account owner.
- An estate, if you serve as an executor and meet certain other criteria.
- A trust, if you serve as the trustee and meet certain other criteria.

.26 Indirect financial interests arise if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary's investment decisions. For example, if you

[3] A financial interest is beneficially owned whether or not the individual or entity is the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or disposition of the interest or to receive the economic benefits of the ownership of the interest.

invest in a defined contribution plan that is not participant directed and you have no authority to supervise or participate in the plan's investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments, in addition to a direct financial interest in the plan.

.27 Extensive examples of various types of financial interests and whether they should be considered as direct or indirect financial interests, including investments in mutual funds, compensation, retirement and savings plans, Section 529 plans, trusts, partnerships, limited liability companies, and insurance products, can be found in Interpretation No. 101-15.

Employment or Association With Client

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

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

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

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

.31 If you are an honorary director or trustee for a client that is a nonprofit charitable, civic, or religious organization, you will not be considered employed by or associated with the client. For this to occur,

a. your position is purely honorary.

b. you may not vote or participate in managing the organization.

c. your position is clearly identified as honorary in any internal or external correspondence.

In addition, if you serve on a client's advisory board, you will not be considered employed by or associated with the client provided

a. the advisory board's function is purely advisory.

b. the advisory board does not appear to make decisions for the client.

c. the advisory board and any decision making boards are separate and distinct bodies.

d. common membership between the advisory board and any decision making groups is minimal.

Practice Tip

Before accepting an invitation to serve on a client's advisory board, a covered member may ask to review the advisory board's governing document to verify that the advisory board's function is indeed purely advisory and that the advisory board indeed does not make decisions for the client.

Unpaid Fees

.32 If a client of the member's firm has not paid fees for previously rendered professional services, then independence is considered to be impaired if, when the report on the client's current year is issued, billed or

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unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided more than one year prior to the date of the report.

Restricted Entities

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

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

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

- making an investment or acquiring a financial interest in an entity.
- entering into a business relationship.
- obtaining a loan or refinancing an existing loan.
- having an immediate family member change employers or assume new responsibilities at an existing job.

Nonattest Services[4]

.36 Be aware of the rules relating to the performance of nonattest services. If you provide nonattest services to restricted entities, you should be familiar with Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .05) that establishes standards and provides guidance regarding the performance of nonattest services. Interpretation No. 101-3 discusses the services that are permitted and prohibited under the ruling, as well as the member's responsibilities for establishing an understanding of the engagement with your client and documenting various aspects of the engagement. If your clients are SEC registrants, you should be aware of the more restrictive SEC rules in this area. Certain other regulators (for example, the GAO) may have more restrictive rules concerning nonattest services, which should be reviewed depending upon the circumstances of the engagement.

.37 The term *nonattest services* includes accounting and consulting services that are not part of an attest engagement.[5] Nonattest services specifically addressed in the rules are as follows:

- Bookkeeping services
- Nontax disbursement services
- Internal audit assistance
- Benefit plan administration
- Investment advisory or management services
- Tax compliance services
- Corporate finance consulting or advisory
- Appraisal, valuation, or actuarial services

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[4] The staff of the AICPA Professional Ethics Division issued nonauthoritative guidance in the form of a frequently asked question (FAQ) regarding performance of nonattaest services. The FAQ document is available on the AICPA Professional Ethics Division's website at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.

[5] As defined in the Code of Professional Conduct, an *attest engagement* is one that requires independence under *Professional Standards*; for example, audits and reviews of financial statements or agreed upon procedures performed under the attestation standards.

- Executive or employee search services
- Business risk consulting
- Information systems design, installation, or integration
- Forensic accounting services

.38 Interpretation No. 101-3 lists three general requirements in order to maintain independence when performing permitted nonattest services.

.39 The first of the three general requirements of Interpretation No. 101-3 states that a member should not perform—or even appear to perform—management functions or make management decisions for an attest client. (However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.)

.40 The second general requirement is that the client must agree to perform the following functions in connection with the engagement:

- Make all management decisions and perform all management functions
- Designate an individual who possesses suitable skill, knowledge, or experience, preferably within senior management, to oversee the services
- Evaluate the adequacy and results of the services performed; and
- Accept responsibility for the results of the services

The member should be satisfied that the client will be able to meet all of these criteria and to make an informed judgment on the results of the member's nonattest services. In assessing whether the designated individual possesses suitable skill, knowledge, or experience, the member should be satisfied that the individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or reperform the services. In cases where the client is unable or unwilling to assume these responsibilities (for example, the client does not have an individual with suitable skill, knowledge, or experience to oversee the nonattest services provided, or is unwilling to perform such functions due to lack of time or desire), the member's provision of these services would impair independence.

.41 The third general requirement is that before performing nonattest services, the member should establish and document in writing his or her understanding with the client (for example, the board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

The understanding might be documented in a separate engagement letter, in the working papers, or in an internal memo, or it might be included in an engagement letter obtained in conjunction with an attest engagement.

.42 The second and third general requirements do not apply to certain routine activities performed by the member, such as, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements that are part of the normal client-member relationship.

.43 In addition, the following are examples of the types of activities that impair independence:

- Authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so

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- Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction
- Having custody of client assets
- Supervising client employees in the performance of their normal recurring activities
- Determining which recommendations of the member should be implemented
- Reporting to the board of directors on behalf of management
- Serving as a client's stock transfer or escrow agent, registrar, general counsel, or its equivalent
- Establishing and maintaining internal controls, including performing ongoing monitoring activities for a client

.44 Additionally, Interpretation No. 101-3 requires you comply with more restrictive independence provisions, if applicable, of certain regulators such as state boards of accountancy, the SEC, and the GAO.

.45 *Report any apparent violations*. If you become aware of any apparent violations of the independence rules, you should report these immediately to the person in your firm responsible for independence matters.

.46 The procedures employed at the engagement level should be designed to ascertain whether the firm and its partners and employees have complied with all applicable independence rules. Overall firm requirements for independence are addressed in Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A).[6]

On the Horizon

In February 2011, the AICPA Professional Ethics Division released an omnibus proposal that contained important clarifying language regarding CPAs' provision of nonattest services. Among them, it made clear that certain bookkeeping and other nonattest services that help clients produce more reliable financial information are permitted under the interpretation even though they may be viewed as maintaining internal control for the client. For example, it clarified that a practitioner is allowed to prepare and maintain monthly account reconciliations for an attest client provided the client accepts responsibility for the services and the other general requirements of Interpretation No. 101-3 are met, such as ensuring that the client reviews and approves the account reconciliations and sufficiently understands the services performed to oversee them. This clarification was made because some have interpreted the current standard as prohibiting these activities and the change reinforces that they are permissible. The exposure draft also proposed that *management functions* be changed to *management responsibilities* and provided additional examples of the types of activities that would be considered to be responsibilities of management and, therefore, impair independence. Comments on the exposure draft were due by May 31, 2011. An overview of planned changes to Interpretation No. 101-3 can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/ClarificationsToNonattestServices.pdf.

Independence Quality Controls

.47 Paragraph .21 of SQCS No. 7[7] states that the firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, where applicable, others subject to independence requirements, maintain independence where required. Independence requirements are set forth in ET section 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Guidance on threats to independence, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time and safeguards to mitigate such threats involving matters that are not explicitly addressed in the AICPA Code of Professional Conduct are set forth in ET section

[6] Refer to section 10,000, "Quality Control," for additional discussion of Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), and establishing and maintaining a firm's system of quality control.

[7] See footnote 6.

100, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*). Such policies and procedures should enable the firm to

a. communicate its independence requirements to its personnel and, where applicable, others subject to them.

b. identify and evaluate circumstances and relationships that create threats to independence and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safe guards, or, if effective safeguards cannot be applied, withdrawing from the engagement.

.48 Such policies and procedures should require

a. the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall effect, if any, on independence requirements.

b. personnel to promptly notify the engagement partner and the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.

c. the accumulation and communication of relevant information to appropriate personnel so that

i. the firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements;

ii. the firm can maintain and update information relating to independence; and

iii. the firm and the engagement partner can take appropriate action regarding identified threats to independence.

.49 The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for

a. personnel to promptly notify the firm of independence breaches of which they become aware.

b. the firm to promptly communicate identified breaches of these policies and procedures and the required corrective actions to

i. the engagement partner who, with the firm, has the responsibility to address the breach; and

ii. other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.

c. confirmation to the firm by the engagement partner and the other individuals referred to previously in subparagraph (b[2]) that the required corrective actions have been taken.

.50 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in ET section 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Written confirmation may be in paper or electronic form.

.51 The purpose of obtaining confirmation and taking appropriate action on information indicating noncompliance is to demonstrate the importance that the firm attaches to independence and keep the issue current for and visible to its personnel.

.52 For all audit or attestation engagements where regulatory or other authorities require the rotation of personnel after a specified period, the firm's policies and procedures should address these requirements.

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Additional Guidance

.53 It is recommended that the auditor document all procedures discussed in this section in his or her working papers.

.54 International independence standards are established by the International Federation of Accountants' (IFAC) International Ethics Standards Board for Accountants and can be found in section 290, *Independence—Audit and Review Engagements*, and section 291, *Independence—Other Assurance Engagements*, of the IFAC's Code of Professional Ethics for Professional Accountants. The IFAC's Code of Professional Ethics for Professional Accountants can be found at http://web.ifac.org/publications/international-ethics-standards-board-for-accountants/code-of-ethics.

.55 For additional guidance practitioners may refer to the AICPA Audit Risk Alert *Independence and Ethics Developments* (product no. 0224710 and reproduced in section 8240). This annual alert informs you of recent developments in the area of independence and ethics for members, including developments in international independence standards discussed previously in paragraph .54. Moreover, the alert helps you understand your independence requirements under the AICPA Code and, if applicable, certain other rule making and standard setting bodies. Also, the alert contains the AICPA Plain English Guide to Independence, which discusses the independence rules of the principal standard setting bodies in plain, straight forward English so you can understand and apply them with greater confidence and ease.

[*The next page is 3181.*]

AAM Section 3120

Obtaining an Understanding of the Entity and Its Environment

General

.01 In accordance with the second standard of field work, "the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures." Obtaining an understanding of the entity and its environment is an essential aspect of performing an audit in accordance with generally accepted auditing standards. In particular, that understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment about assessing risks of material misstatement of the financial statements and responding to those risks throughout the audit, for example, when

- establishing materiality for planning purposes and evaluating whether that judgment remains appropriate as the audit progresses;
- considering the appropriateness of the selection and application of accounting policies and the adequacy of financial statement disclosures;
- identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going-concern assumption, complex or unusual transactions, or considering the business purpose of transactions;
- developing expectations for use when performing analytical procedures;
- designing and performing further audit procedures to reduce audit risk to an appropriately low level; and
- evaluating the sufficiency and appropriateness of audit evidence obtained, such as evidence related to the reasonableness of management's assumptions and of management's oral and written representations.

.02 The auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment, including its internal control. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures. The depth of the overall understanding that the auditor obtains in performing the audit is less than that possessed by management in managing the entity.

.03 Obtaining an understanding of the entity and its environment, including its internal control, is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. Throughout this process, the auditor should also follow the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*). See further discussion in section 3145, "Fraud."

Risk Assessment Procedures

.04 Audit procedures performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels are referred to as *risk assessment procedures*. The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels.

.05 The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a. Inquiries of management and others within the entity

b. Analytical procedures

c. Observation and inspection

.06 Risk assessment procedures are designed to gather and evaluate information about the client and are not specifically designed as substantive procedures or as tests of controls. Nevertheless, in performing risk assessment procedures, the auditor may obtain evidence about relevant assertions or the effectiveness of controls.

Inquiry of Management and Others

.07 Although much of the information obtained by inquiry can be obtained from management, accounting personnel, and others involved in the financial reporting process, it is often helpful to direct inquires to others within the entity. For example, people who work in production, sales, or internal audit, as well as individuals employed at different levels within the organization can provide a different perspective that helps identify risks of material misstatement. Inquiries of others can also help corroborate or provide additional details to the statements and representations made by management and accounting personnel. The following table provides examples of other individuals within the entity who might be able to help the auditor identify and assess the risks of material misstatement.

Examples of Inquires of Others Within the Entity

.08

Inquiries of these individuals (outside of management or the financial reporting process, or both)	*May help the auditor understand*
Those charged with governance	• the environment in which the financial statements are prepared. • whether they have knowledge of any fraud or suspected fraud. • how they exercise oversight of the entity's programs and controls that address fraud. • their views on where the company is most vulnerable to fraud. • how financial statements are used.
Internal audit personnel	• the design and operating effectiveness of internal control. • internal audit activities related to internal control over financial reporting. • whether management has responded satisfactorily to internal audit findings. • their views on where the company is most vulnerable to fraud.
Employees involved in the initiation, processing, or recording of complex or unusual transactions	• the controls over the selection and application of accounting policies related to those transactions. • the business rationale for those transactions.

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Inquiries of these individuals (outside of management or the financial reporting process, or both)	*May help the auditor understand*
IT systems users	• how IT users identify changes to IT systems and how frequently those changes occur. • how users "work around" IT systems for those circumstances where the IT system does not support them. • how logical access to data and applications is controlled. • how remote access to the system is controlled. • excessive system down time and other indicators that the system is not functioning properly.
In-house legal counsel	• litigation. • compliance with laws and regulations. • fraud or suspected fraud. • warranties. • post sales obligations. • arrangements such as joint ventures. • the meaning of certain contract terms.
Marketing, sales, or production personnel	• marketing strategies. • sales trends. • production strategies. • contractual arrangements with customers. • any pressures to meet budgets or change reported performance measures.

Analytical Procedures

.09 AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), specifies that the auditor should apply analytical procedures in planning the audit. The objective of these procedures is to help the auditor understand the client and its environment and, ultimately, to assess the risks of material misstatement. As such, the auditor may consider the analytical procedures performed during audit planning to be a risk assessment procedure that provides some broad audit evidence to support the opinion on the financial statements.

.10 Refer to paragraphs .06–.08 of AU section 329 for additional guidance on the performance of analytical procedures in planning the audit.

.11 The results of analytical procedures may help the auditor obtain an understanding of the entity. For example, analytical procedures may be helpful in identifying

- the existence of unusual transactions or events, which may indicate the presence of significant risks, and
- amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. For example, an unexpected amount, ratio, or trend may be the result of a misstatement that was not prevented or detected and corrected by the client's system of internal control.

Observations and Inspection of Documents

.12 The auditor may use observation and the inspection of documents to support the responses received to the inquiries of management and others. Additionally, the observations and inspections will provide the auditor with further information about the entity and its environment, including its internal control, that might not otherwise be obtained.

.13 The procedures performed to observe activities and inspect documents typically include the following:

- Observation of client activities and operations
- Visits to the client's premises and plant facilities
- Inspection of documents, records, and internal control manuals
- Reading reports prepared by management (such as quarterly management reports and interim financial statements)
- Reading minutes of board of directors' meetings and other documents prepared by those charged with governance and internal audit
- Tracing transactions through the financial reporting information system (walkthroughs)

A Mix of Procedures

.14 The auditor is not required to perform all the risk assessment procedures described previously for each aspect of the understanding described in the following section. However, all the risk assessment procedures should be performed by the auditor in the course of obtaining the required understanding.

Discussion Among the Audit Team

.15 The members of the audit team, including the auditor with final responsibility for the audit, should discuss the susceptibility of the entity's financial statements to material misstatements. The objectives of this discussion are for team members to

- gain a better understanding of the potential for material misstatements of the financial statements resulting from fraud or error in the specific areas assigned to them, and
- understand how the results of the audit procedures they perform may affect other aspects of the audit, including the decisions about the nature, timing, and extent of further audit procedures.

.16 This discussion could be held concurrently with the discussion among the audit team that is specified by AU section 316 to discuss the susceptibility of the entity's financial statements to material misstatement due to fraud. See section 3145 for further discussion on fraud.

.17 Topics for audit team discussion include the following:

- Areas of significant audit risk
- Unusual accounting procedures used by the client
- Important control systems
- Significant IT applications and how the client's use of IT may affect the audit
- Areas susceptible to management override of controls
- Materiality at the financial level and at the account level and tolerable misstatement
- How materiality will be used to determine the extent of testing
- The application of generally accepted accounting principles to the client's facts and circumstances and in light of the entity's accounting policies

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- The need to
  - exercise professional skepticism throughout the engagement
  - remain alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred
  - follow up rigorously on any indications of a material misstatement

.18 The auditor should exercise professional judgment to determine logistical matters relating to the audit discussion, such as who should participate, how and when the discussion should occur, and its extent. Key members of the audit team, including the auditor with final responsibility, should be involved in the discussion.

.19 When considering who should participate in the discussion, the auditor also may determine that an IT specialist or other individual possessing specialized skills is needed on the audit team and, therefore, include that individual in the discussion.

Understanding Specified Aspects of the Entity and Its Environment

.20 The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

a. Industry, regulatory, and other external factors

b. Nature of the entity

c. Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements

d. Measurement and review of the entity's financial performance

e. Internal control, which includes the selection and application of accounting policies

.21 The nature, timing, and extent of the risk assessment procedures performed depend on the circumstances of the engagement, such as the size and complexity of the entity and the auditor's experience with it. In addition, identifying significant changes in any of the previously mentioned aspects of the entity from prior periods is particularly important in gaining a sufficient understanding of the entity to identify and assess risks of material misstatement.

Industry, Regulatory, and Other External Factors

.22 The auditor should obtain an understanding of relevant industry, regulatory, and other external factors. These factors include industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, relevant accounting pronouncements, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors, such as general economic conditions.

.23 The industry in which the entity operates may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (such as political, economic, social, technical, and competitive). For example, long term contracts may involve significant estimates of revenues and costs that give rise to risks of material misstatement of the financial statements. Similarly, regulations may specify certain financial reporting requirements for the industry in which the entity operates. In such cases, the auditor should consider whether the audit team includes members with sufficient relevant knowledge and experience. If management fails to comply with such regulations, its financial statements may be materially misstated.

Nature of the Entity

.24 The auditor should obtain an understanding of the nature of the entity. The nature of an entity refers to the entity's operations, its ownership, governance, the types of investments that it is making and plans to make, the way that the entity is structured, and how it is financed. An understanding of the nature of an entity enables the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements.

Objectives and Strategies and Related Business Risks

.25 The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risks that may result in material misstatement of the financial statements. The entity conducts its business in the context of industry, regulatory, and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the operational approaches by which management intends to achieve its objectives. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic and the entity's strategies and objectives change over time.

.26 Business risk is broader than the risk of material misstatement of the financial statements, although it includes the latter. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Usually management identifies business risks and develops approaches to address them. Such a risk assessment process is part of internal control and is discussed in paragraphs .76–.80 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*).

Measurement and Review of the Entity's Financial Performance

.27 The auditor should obtain an understanding of the measurement and review of the entity's financial performance. Performance measures and their review indicate to the auditor aspects of the entity's performance that management and others consider to be important. Performance measures, whether external or internal, create pressures on the entity that, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Obtaining an understanding of the entity's performance measures assists the auditor in considering whether such pressures result in management actions that may have increased the risks of material misstatement.

.28 Internally generated information used by management for this purpose may include key performance indicators (financial and nonfinancial); budgets; variance analysis; subsidiary information and divisional, departmental, or other level performance reports; and comparisons of an entity's performance with that of competitors. External parties may also measure and review the entity's financial performance. For example, external information, such as analysts' reports and credit rating agency reports, may provide information useful to the auditor's understanding of the entity and its environment. Such reports may be obtained from the entity being audited or from websites.

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Internal Control

.29 Refer to section 3125, "Obtaining and Understanding of Internal Control," for the discussion of internal control.

Documentation

.30 The auditor should document the key elements of the understanding obtained regarding each of the aspects of the entity and its environment, including each of the components of internal control (discussed in section 3125) to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures. See section 6000 for additional discussion on audit documentation.

[*The next page is 3201.*]

AAM Section 3125

Obtaining an Understanding of Internal Control

Introduction

.01 *Internal control* is broadly defined by the Committee of Sponsoring Organizations of the Treadway Commission as a process designed to provide reasonable assurance regarding the achievement of the entity's objectives in the following categories: (*a*) reliability of financial reporting, (*b*) effectiveness and efficiency of operations, and (*c*) compliance with applicable laws and regulations. Internal control is effected by those charged with governance, management, and other personnel.

.02 The previous definition reflects certain fundamental concepts that follow:

A process. Internal control is a process. It is not one event or circumstance, but a series of actions that permeate an entity's activities. These actions are pervasive, and are inherent in the way management runs the business.

People. Internal control is effected by people. It is not accomplished by policy manuals and forms, but the people of an organization, what they do and say. People need to know their responsibilities and limits of authority.

Reasonable assurance. Internal control, no matter how well designed and operated, can provide only reasonable assurance to management and the board of directors regarding achievement of an entity's objectives.

Achievement of objectives. Internal control is geared to the achievement of entity objectives. The definition of these objectives provides auditors with a useful framework for understanding and analyzing internal control.

.03 Auditors should obtain an understanding of their client's internal control during the planning phase of every audit. Paragraph .40 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), states the following:

> The auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures.

.04 As a practical matter, the previous requirement raises the following questions:

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

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

What Auditors Should Understand About Internal Control

.06 A *sufficient* understanding of internal control means the following:

- The auditor should obtain a sufficient understanding by performing risk assessment procedures to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented.
- This understanding is ordinarily limited to controls that pertain to the entity's objective of preparing reliable financial statements for external purposes.
- That one objective can be broken into five components, and an auditor should obtain an understanding of each of the five components.

.07 Obtaining an understanding of controls is different from testing the operating effectiveness of controls. Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. Implementation of a control means that the control exists and that the entity is using it. The auditor should consider the design of a control in determining whether to consider its implementation. In contrast, the objective of testing the operating effectiveness of controls is to determine whether the controls, as designed, prevent or detect a material misstatement. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

.08 *The Jones family owns and operates several neighborhood grocery stores in Anytown. On a monthly basis, the controller of Jones Grocery performs bank reconciliations for all the bank accounts. For planning purposes, the auditor of Jones Grocery should determine whether this control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements and determine whether the controller actually performs the reconciliations. Not testing, but identifying controls are a key part of audit planning.*

.09 AU section 314 provides a framework to help auditors obtain their understanding of internal control. That framework is built on two basic concepts: objectives and components.

.10 Internal control is a process designed to provide reasonable assurance regarding the achievement of entity *objectives*. Entities generally have the following three objectives:

Financial reporting. This objective relates to the preparation of reliable published financial statements.

Operations. This objective relates to effective and efficient use of the entity's resources.

Compliance. This objective relates to the entity's compliance with applicable laws and regulations.

.11 *The bank reconciliation performed by the Jones Grocery controller is an example of a control that relates primarily to the **financial reporting** objective. Jones also has an inventory tracking and management system that allows each store manager to track inventory levels and order new items before they stock-out. This control activity is part of the **operations** objective. Each store also has a small deli that prepares sandwiches and hot entrees. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the entity's **compliance** objective.*

.12 Ordinarily, relevant controls for an audit relate to the financial reporting objective. Controls relating to operations and compliance objectives that are not relevant to an effective audit need not be considered. It is a matter of the auditor's professional judgment, as to the controls or combination of controls that may be assessed. However, as stated in paragraph .115 of AU section 314, for significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities and determine whether they have been implemented.

.13 *The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery, but ordinarily will not relate to the audit of the company's financial statement. The*

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auditor of Jones may wish to inquire and document these controls for client service or other purposes, but because these controls are not relevant to the audit, he or she is not required to do so.

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

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

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

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

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

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

.19 AU section 314 provides a framework that separates each financial reporting objective into five components. These components represent what is needed to achieve the entity's objectives. The components of internal control are briefly described as follows:

Control environment. The control environment component is the foundation upon which all other components of internal control are based, and it sets the tone of an organization. A small business can have unique advantages in establishing a strong control environment. Employees in many smaller businesses interact more closely with top management and are directly influenced by management actions. Through day-to-day practices and actions, management can effectively reinforce the company's fundamental values and directives. The close working relationship also enables senior management to quickly recognize when employees' actions need modification.

Risk assessment. Risk assessment, as it relates to the objective of reliable financial reporting, involves identification and analysis of the risks of material misstatement. Establishment of financial reporting objectives articulated by a set of financial statement assertions for significant accounts is a precondition to the risk assessment process. Risk assessment in small businesses can be relatively efficient, often because in-depth knowledge of the company's operations enables the owner and management to have firsthand information of where risks exist. In carrying out their normal responsibilities, including obtaining information gained from employees, customers, suppliers, and others, these managers identify risks inherent in business processes. In addition to focusing on operations and compliance risks, they are positioned to consider the following risks to reliable financial reporting:

- Failing to capture and record all transactions
- Recording assets that do not exist or transactions that did not occur
- Recording transactions in the wrong period or wrong amount or misclassifying transactions

- Losing or altering transactions once recorded
- Failing to gather pertinent information to make reliable estimates
- Recording inappropriate journal entries
- Improperly accounting for transactions or estimates
- Inappropriately applying formulas or calculations

Control activities. Control activities are the policies and procedures that help ensure that management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties. When resource constraints compromise the ability to segregate duties, many smaller companies use certain compensating controls to achieve the objectives.

Information and communication systems. Information systems identify, capture, process, and distribute information supporting the achievement of financial reporting objectives. Information systems in small businesses are likely to be less formal than in large ones, but their role is just as significant. Many small businesses rely more on manual or standalone IT applications than complex integrated applications. Effective internal communication between top management and employees may be facilitated in smaller companies due to fewer levels and numbers of personnel and greater visibility and availability of the owner. Internal communication can take place through frequent meetings and day-to-day activities in which the owner and other managers participate.

Monitoring. Internal control systems need to be monitored, which is a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Managers of many smaller businesses have high-level firsthand knowledge of company activities, and their close involvement in operations positions them to identify variances from expectations and potential inaccuracies in reported financial information.

.20 Some control components, for example the control environment, will have a pervasive effect on the entity's activities. Other components, for example control activities, will be directed primarily toward the achievement of one or more of the three objectives described in paragraph .10 in this section. Auditors are generally interested only in those components of internal control that have a pervasive effect on the entity and those that are directly related to the reliability of financial reporting.

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

.22 The internal control framework described here and in section 4200 is only a means to help auditors consider the effect of an entity's internal control in an audit. An auditor's primary concern is *not* the classification of a specific control into any particular component and related objective. Rather, an auditor's primary concern is whether, and how, a specific control prevents or detects and corrects material misstatements in relevant assertions related to classes of transactions, account balances, or disclosures, rather than its classification into any particular component. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions. Such controls may exist in any of the five components.

.23 *Andrea Auditor audits Jones Grocery. As on all audits, she should obtain an understanding of internal control sufficient to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures. To achieve this, she organizes her inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objective. As a result of performing her procedures, she discovers the client's bank reconciliation procedures. Should a bank reconciliation be considered a* control activity? *What about*

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the fact that someone follows up and investigates old or unusual reconciling items. Is that considered a monitoring *activity?*

.24 *The issue of how to classify a particular control is irrelevant for Andrea's purposes. As an auditor, her primary consideration is to understand how the bank reconciliations, whether individually or in combination with other controls, affect financial statement assertions relating to cash.*

How an Auditor Obtains an Understanding of Internal Control

.25 The auditor should obtain a sufficient understanding of internal control by performing risk assessment procedures (inquiries of management and others within the entity regarding internal control matters, analytical procedures, observation of entity activities, the performance of control activities, or both, and inspection of the documentation of prescribed control procedures, the control activity, or both) to evaluate the design of controls relevant to an audit of financial statements and to determine whether they have been implemented. Procedures to obtain audit evidence about the design and implementation of relevant controls may include inquiring of entity personnel, observing the application of specific controls, inspecting documents and reports, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient to evaluate the design of a control relevant to an audit and to determine whether it has been implemented.

.26 Auditors might consider the types of misstatements that occurred in prior audits (for example, whether they were associated with accounting estimates, whether they were routine errors that resulted from a lack of control consciousness, or whether they resulted from lack of sufficient personnel). This knowledge of prior misstatements can help an auditor focus his or her inquiries on those areas and whether changes have been made to internal control to prevent those misstatements in the future.

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

.28 *Jones Grocery purchased a commercially available software package for independent grocers. During 20X1, Jones installed the general ledger system and the cash receipts/disbursements and accounts payable modules. As part of performing her 20X1 audit, Andrea Auditor obtained an understanding of the software package and the modules that were installed. For her 20X2 audit, Andrea should focus on changes made to the system since 20X1. For example, she might inquire about the installation of other modules (such as inventory) or updated versions of the software package.*

.29 Some controls are documented in policy and procedure manuals, flowcharts, source documents, journals, and ledgers. In these cases, inspection of the documentation and inquiries of entity personnel may provide a sufficient understanding to assess the risks of material misstatement and design the nature, timing, and extent of further audit procedures.

.30 *When Jones Grocery receives a bill, it is input directly into the accounts payable module of their software package. The computer generates an accounts payable aging and a cash requirements report that indicates when each bill should be paid. The accounts payable module interfaces with the general ledger system to automatically post and update the appropriate general ledger account whenever bills are received or paid. To obtain her understanding of the accounts payable system, Andrea performed a "walk-through." She made inquiries of Jones personnel and obtained copies of bills and the reports generated by the computer. She "walked through" the example bills to see how they were included in the computer reports and how totals from those reports were posted to the general ledger. She also made inquiries related to the completeness assertion, that is, how does Jones ensure that* all *bills are entered into the system? Andrea observed the Jones employee performing those control procedures.*

.31 Documentation may not be available for some controls. For example, the understanding of certain aspects of the control environment, such as management integrity, may be obtained through previous experience updated by inquiries of management and observation of their actions. Although documentation

may not be available, the auditor is still responsible for documenting his or her understanding of the components of internal control.

Documenting the Understanding

.32 The auditor should document the key elements of the understanding obtained regarding each of the components of internal control, to assess the risks of material misstatement of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures. The form and extent of this documentation is influenced by the nature and complexity of the entity's controls. For example, documentation of the understanding of internal control of a complex information system in which a large volume of transactions are electronically initiated, authorized, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed (for example, long-term debt), documentation in the form of a memorandum may be sufficient. Generally, the more complex the entity's internal control and the more extensive the procedures performed by the auditor, the more extensive the auditor should document his or her work.

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AAM Section 3130

Assessing the Risks of Material Misstatement

General

.01 Knowledge an auditor acquires about a client encompasses a broad range of information, including the following:

- Industry, regulatory, and other external factors affecting the client
- The nature of the client, including its operations and organizational structure
- The client's objectives, strategies, and related business risks, some of which will give rise to risks affecting the financial statements
- How management measures and reviews the company's financial performance
- An understanding of the internal controls that are in use at the entity, including an understanding of the use of IT and the controls designed and used within the IT system

This knowledge of a client forms the basis for identifying risks and evaluating how these risks could result in financial statement misstatements.

.02 The auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. For this purpose, the auditor should

- identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and considering the classes of transactions, account balances, and disclosures in the financial statements.
- relate the identified risks to what can go wrong at the relevant assertion level.
- consider whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
- consider the likelihood that the risks could result in a material misstatement of the financial statements.

.03 It is not acceptable to simply deem risk to be "at the maximum." The auditor should use information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment. The auditor should use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed, such as substantive tests. When the risk assessment is based on an expectation that controls are operating effectively to prevent or detect material misstatement, individually or when aggregated, at the relevant assertion level, the auditor should perform tests of the controls that the auditor has determined to be suitably designed to prevent or detect a material misstatement in the relevant assertion to obtain audit evidence that the controls are operating effectively, as described in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*).

.04 The auditor should determine whether the identified risks of material misstatement relate to specific relevant assertions related to classes of transactions, account balances, and disclosures, or whether they relate more pervasively to the financial statements taken as a whole and potentially affect many relevant assertions.

Financial Statement Assertions

.05 Paragraphs .14–.19 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), discuss the use of assertions in obtaining audit evidence. In representing that the financial statements are fairly presented in accordance with generally accepted accounting procedures, management implicitly or explicitly makes assertions regarding the recognition, measurement, and disclosure of information in the financial statements and related disclosures. Assertions used by the auditor fall into the following categories:

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Categories of Assertions

	Description of Assertions		
	Classes of transactions and events during the period	*Account balances at the end of the period*	*Presentation and disclosure*
Occurrence/Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	Disclosed events and transactions pertain to the entity
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/valuation and allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described, and information in disclosures is expressed clearly.

.06 The auditor should use relevant assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor should use relevant assertions in assessing risks by considering the different types of potential misstatements that may occur, and then designing further audit procedures that are responsive to the assessed risks.

Assessing Risks at the Financial Statement Level

.07 Risks of material misstatement at the financial statement level are those risks that relate pervasively to the financial statements and potentially affect many individual assertions. Risks at the financial statement level may derive in particular from a weak control environment. The nature of the risks arising from a weak control environment is such that they are not likely to be confined to specific individual risks of material misstatement in particular classes of transactions, account balances, and disclosures. Rather, weaknesses such as management's lack of competence may have a more pervasive effect on the financial statements and may require an overall response by the auditor.

.08 Characteristics of financial statement level risks that are relevant for audit purposes include the following:

Financial statement level risks can affect many assertions. By definition, financial statement level risks may result in material misstatements of several accounts or assertions. For example, a lack of control over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of identified risks of material misstatement are not known.

Assessing financial statement level risks requires significant judgment. Ultimately, the auditor should relate identified risks of misstatement to what can go wrong. For example, suppose that while performing risk assessment procedures to gather information about the control environment, the auditor discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in increased risks of a misstatement of the financial statements, but it will be a matter of the auditor's professional judgment to determine the following:

- The accounts and relevant assertions that could be affected
- The likelihood that a financial statement misstatement will result from the increased risks
- The significance of any misstatement

Risks at the financial statement level may not be identifiable with specific assertions. Control weaknesses at the financial statement level can render well designed activity level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult, and may not even be possible. As another example, a client may have excellent data input controls at the application level. But if poorly designed, IT general controls may allow many unauthorized personnel the opportunity to access and inappropriately change the data and the well designed input controls will be rendered ineffective. Also, strengths in financial statement level controls such as an overall culture of ethical behavior may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and therefore the assessment of the risks of material misstatement) is subjective and may vary from client to client.

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Assessing Risks at the Assertion Level

.09 In making risk assessments, the auditor should identify the controls that are likely to prevent or detect and correct material misstatements in specific relevant assertions. Generally, the auditor gains an understanding of controls and relates them to relevant assertions in the context of processes and systems in which they exist. Doing so is useful because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other elements of internal control, will be sufficient to address a risk.

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

.11 Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing or detecting and correcting misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

Significant Risks That Require Special Audit Consideration

.12 As part of the assessment of the risks of material misstatement, the auditor should determine which of the risks identified are, in the auditor's judgment, risks that require special audit consideration (such risks are defined as *significant risks*). One or more significant risks normally arise on most audits. In exercising this judgment, the auditor should consider inherent risk to determine whether the nature of the risk, the likely magnitude of the potential misstatement including the possibility that the risk may give rise to multiple misstatements, and the likelihood of the risk occurring are such that they require special audit consideration. AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), establishes standards and provides guidance to the auditor in determining whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence. The auditor should evaluate the design of the entity's related controls, including relevant control activities, over such risks and determine whether they are adequate and have been implemented. Paragraphs .45 and .53 of AU section 318 describe the consequences for further audit procedures of identifying risks as significant.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

.13 As part of the risk assessment previously described in paragraph .12, the auditor should evaluate the design and determine the implementation of the entity's controls, including relevant control activities, over those risks for which, in the auditor's judgment, it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures. The consequences for further audit procedures of identifying such risks are described in paragraph .24 of AU section 318.

Revision of Risk Assessment

.14 The auditor's assessment of the risks of material misstatement at the relevant assertion level is based on available audit evidence and may change during the course of the audit as additional audit evidence is obtained. In particular, the risk assessment may be based on an expectation that controls are operating effectively to prevent or detect and correct a material misstatement at the relevant assertion level. In

performing tests of controls to obtain audit evidence about their operating effectiveness, the auditor may obtain audit evidence that controls are not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures, the auditor may detect misstatements in amounts or frequency that is greater than is consistent with the auditor's risk assessment. When the auditor obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the auditor originally based the assessment, the auditor should revise the assessment and should further modify planned audit procedures accordingly. See paragraphs .70 and .74 of AU section 318 for further guidance.

Documentation

.15 The auditor should document (*a*) the assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level and the basis for the assessment and (*b*) the risks identified and related controls evaluated as a result of the requirements for significant risks.

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AAM Section 3140

Audit Risk and Materiality

General

.01 Audit risk and materiality, among other matters, need to be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures. The existence of audit risk is recognized in the description of the responsibilities and functions of the independent auditor. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. In other words, audit risk is the risk that the auditor will issue an unqualified opinion on financial statements that are materially incorrect.

.02 Financial statements are materially misstated when they contain misstatements whose effect, individually or in the aggregate, are important enough to cause them not to be presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP). Materiality is the criterion used by auditors to distinguish between unimportant and important matters. The auditor's consideration of materiality is a matter of professional judgment and is influenced by a perception of the needs of users of the financial statements. The perceived needs of users are recognized in the discussion of materiality in FASB Concepts Statement No. 2, *Qualitative Characteristics of Accounting Information*, which defines materiality as

> The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

Nature and Causes of Misstatements

.03 The representation in the auditor's standard report regarding fair presentation, in all material respects, in conformity with generally accepted accounting principles indicates the auditor's belief that the financial statements, taken as a whole, are not materially misstated. Misstatements can result from errors or fraud.[1] and may consist of any of the following:

a. An inaccuracy in gathering or processing data from which financial statements are prepared

b. A difference between the amount, classification, or presentation of a reported financial statement element, account, or item and the amount, classification, or presentation that would have been reported under GAAP

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

d. A financial statement disclosure that is not presented in conformity with GAAP

e. The omission of information required to be disclosed in conformity with GAAP

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

g. Management's judgments concerning an accounting estimate or the selection or application of accounting policies that the auditor may consider unreasonable or inappropriate

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[1] The auditor's consideration of illegal acts and responsibility for detecting misstatements resulting from illegal acts is defined in AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*). See section 3150, *Illegal Acts*. For those illegal acts that are defined in that statement as having a direct and material effect on the determination of financial statement amounts, the auditor's responsibility to detect misstatements resulting from such illegal acts if the same as that for errors or fraud.

.04 Misstatements may be of two types: known and likely, defined as follows:

Known misstatements. These are specific misstatements identified during the audit arising from the incorrect selection or misapplication of accounting principles or misstatements of facts identified, including, for example, those arising from mistakes in gathering or processing data and the overlooking or misinterpretation of facts.

Likely misstatements. These are misstatements that

a. arise from differences between management's and the auditor's judgments concerning accounting estimates that the auditor considers unreasonable or inappropriate (for example, because an estimate included in the financial statements by management is outside of the range of reasonable outcomes the auditor has determined).

b. the auditor considers likely to exist based on an extrapolation from audit evidence obtained (for example, the amount obtained by projecting known misstatements identified in an audit sample to the entire population from which the sample was drawn).

.05 The term *errors* refers to unintentional misstatements of amounts or disclosures in financial statements. The term *fraud* refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Two types of misstatements resulting from fraud are relevant to the auditor's consideration in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets. These two types of misstatements are further described in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*).

.06 See section 3145, "Fraud," for a further discussion on fraud.

.07 Although the auditor has no responsibility to plan and perform the audit to detect immaterial misstatements, there is a distinction in the auditor's response to detected misstatements depending on whether those misstatements are caused by error or fraud. When the auditor encounters evidence of potential fraud, regardless of its materiality, the auditor should consider the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

Considerations at the Financial Statements Level

.08 The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of

a. determining the extent and nature of risk assessment procedures.

b. identifying and assessing the risks of material misstatement.

c. determining the nature, timing, and extent of further audit procedures.

d. evaluating whether the financial statements taken as a whole are presented fairly, in all material respects, in conformity with GAAP.

.09 Audit risk is a function of the risk that the financial statements prepared by management are materially misstated and the risk that the auditor will not detect such material misstatement. The auditor should consider audit risk in relation to the relevant assertions related to individual account balances, classes of transactions, and disclosures and at the overall financial statement level. The auditor should perform risk assessment procedures to assess the risks of material misstatement both at the financial statement and the relevant assertion levels. The auditor may reduce audit risk by determining overall responses and designing the nature, timing, and extent of further audit procedures based on those assessments.

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.10 The auditor should perform the audit to reduce audit risk to a low level that is, in the auditor's professional judgment, appropriate for expressing an opinion on the financial statements. Audit risk may be assessed in quantitative or nonquantitative terms.

.11 The considerations of audit risk and materiality are affected by the size and complexity of the entity and the auditor's experience with and knowledge of the entity and its environment, including its internal control. As discussed in the following heading, "Considerations at the Individual Account Balance, Class of Transactions, or Disclosure Level," certain entity related factors also affect the nature, timing, and extent of further audit procedures with respect to relevant assertions related to specific account balances, classes of transactions, and disclosures.

.12 In considering audit risk at the overall financial statement level, the auditor should consider risks of material misstatement that relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. Risks of this nature often relate to the entity's control environment and are not necessarily identifiable with specific relevant assertions at the class of transactions, account balance, or disclosure level. Such risks may be especially relevant to the auditor's consideration of the risks of material misstatement arising from fraud, for example, through management override of internal control. In developing responses to the risks of material misstatement at the overall financial statement level, the auditor should consider such matters as the knowledge, skill, and ability of personnel assigned significant engagement responsibilities; whether certain aspects of the engagement need the involvement of a specialist; and the appropriate level of supervision of assistants.

Considerations at the Individual Account Balance, Class of Transactions, or Disclosure Level

.13 In determining the nature, timing, and extent of audit procedures to be applied to a specific account balance, class of transactions, or disclosure, the auditor should design audit procedures to obtain reasonable assurance of detecting misstatements that the auditor believes, based on the judgment about materiality, could be material, when aggregated with misstatements in other balances, classes, or disclosures, to the financial statements taken as a whole.

.14 The auditor should consider audit risk at the individual account balance, class of transactions, or disclosure level because such consideration directly assists in determining the nature, timing, and extent of further audit procedures for the relevant assertions related to balances, classes, or disclosures. The auditor should seek to reduce audit risk at the individual balance, class, or disclosure level in such a way that will enable the auditor, at the completion of the audit, to express an opinion on the financial statements taken as a whole at an appropriately low level of audit risk.

.15 At the account balance, class of transactions, relevant assertion, or disclosure level, audit risk consists of (*a*) the risk (consisting of inherent risk and control risk) that the relevant assertions related to balances, classes, or disclosures contain misstatements (whether caused by error or fraud) that could be material to the financial statements when aggregated with misstatements in other relevant assertions related to balances, classes, or disclosures and (*b*) the risk (detection risk) that the auditor will not detect such misstatements. These components of audit risk may be assessed in quantitative terms, such as percentages, or in nonquantitative terms such as *high*, *medium*, or *low* risk. The way the auditor should consider these component risks and combines them involves professional judgment and depends on the auditor's approach or methodology.

.16 *Inherent risk* is the susceptibility of a relevant assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related account balances, classes of transactions, and disclosures than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is more susceptible to theft than an inventory of coal. Accounts consisting of amounts derived from accounting estimates that are subject to significant measurement uncertainty pose greater risks than do accounts consisting of relatively routine, factual data. External circumstances giving rise to business risks also influence inherent risk. For example, technological developments might make a particular product

obsolete, thereby causing inventory to be more susceptible to overstatement. In addition to those circumstances that are peculiar to a specific relevant assertion, factors in the entity and its environment that relate to several or all of the classes of transaction, account balances, or disclosures may influence the inherent risk related to a specific relevant assertion. These latter factors include, for example, a lack of sufficient working capital to continue operations or a declining industry characterized by a large number of business failures.

.17 *Control risk* is the risk that a misstatement that could occur in a relevant assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the entity's internal control. That risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to preparation of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control.

.18 Inherent risk and control risk are the entity's risks, that is, they exist independently of the audit of financial statements. AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), and other AU sections describe the risks of material misstatement as the auditor's combined assessments of inherent risk and control risk; however, the auditor may make separate assessments of inherent risk and control risk. Furthermore, auditors may implement the concepts surrounding the assessment of inherent and control risks and responding to the risks of material misstatement in different ways as long as they achieve the same result.

.19 The auditor should assess the risks of material misstatement at the relevant assertion level as a basis for further audit procedures. Although that assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment. This basis may be obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, including its internal control, and through the performance of suitable tests of controls to obtain audit evidence about the operating effectiveness of controls, where appropriate.

.20 *Detection risk* is the risk that the auditor will not detect a misstatement that exists in a relevant assertion that could be material, either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. Detection risk cannot be reduced to zero because the auditor does not examine 100 percent of an account balance or a class of transactions and because of other factors. Such other factors include the possibility that an auditor might select an inappropriate audit procedure; misapply an appropriate audit procedure; or misinterpret the audit results. These other factors might be addressed through adequate planning; proper assignment of personnel to the engagement team; the application of professional skepticism, supervision, and review of the audit work performed; and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Detection risk can be disaggregated into additional components of tests of details risk and substantive analytical procedures risk.

.21 Detection risk relates to the substantive audit procedures and is managed by the auditor's response to risks of material misstatement. For a given level of audit risk, detection risk should bear an inverse relationship to the risks of material misstatement at the relevant assertion level. The greater the risks of material misstatement, the less the detection risk that can be accepted by the auditor. Conversely, the lower the risks of material misstatement, the greater the detection risk that can be accepted by the auditor. However, the auditor should perform substantive procedures for all relevant assertions related to material classes of transactions, account balances, and disclosures.

Materiality

.22 The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of users of financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations.

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Determining Materiality for the Financial Statements Taken as a Whole When Planning the Audit

.23 The auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. Determining a materiality level for the financial statements taken as a whole helps guide the auditor's judgments in identifying and assessing the risks of material misstatements and in planning the nature, timing, and extent of further audit procedures. This materiality level does not, however, establish a threshold below which identified misstatements are always considered to be immaterial when evaluating those misstatements and their effect on the financial statements and the auditor's report thereon.

.24 The auditor often may apply a percentage to a chosen benchmark as a step in determining materiality for the financial statements taken as a whole. When identifying an appropriate benchmark, the auditor may consider factors such as the following:

- The elements of the financial statements (for example, assets, liabilities, equity, income, and expenses) and the financial statement measures defined in GAAP (for example, financial position, financial performance, and cash flows), or other specific requirements
- Whether there are financial statement items on which, for the particular entity, users' attention tends to be focused (for example, for the purpose of evaluating financial performance)
- The nature of the entity and the industry in which it operates
- The size of the entity, nature of its ownership, and the way it is financed

Examples of benchmarks that might be appropriate, depending on the nature and circumstances of the entity, include total revenues, gross profit, and other categories of reported income, such as profit before tax from continuing operations. Profit before tax from continuing operations may be a suitable benchmark for profit oriented entities but may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit entity, or when it is an owner managed business where the owner takes much of the pretax income out of the business in the form of remuneration. For asset based entities (for example, an investment fund) an appropriate benchmark might be net assets. Other entities (for example, banks and insurance companies) might use other benchmarks.

.25 When determining materiality, the auditor should consider prior periods' financial results and financial positions, the period-to-date financial results and financial position, and budgets or forecasts for the current period, taking account of significant changes in the entity's circumstances (for example, a significant business acquisition) and relevant changes of conditions in the economy as a whole or the industry in which the entity operates.

.26 Once materiality is established, the auditor should consider materiality when planning and evaluating the same way regardless of the inherent business characteristics of the entity being audited.

Tolerable Misstatement

.27 The initial determination of materiality is made for the financial statement taken as a whole. However, the auditor should allow for the possibility that some misstatements of lesser amounts than the materiality levels could, in the aggregate, result in a material misstatement of the financial statements.

.28 For example, suppose that for planning purposes the auditor determined materiality to be $100,000, and he or she designed his or her audit to provide reasonable assurance that misstatements of that magnitude were detected. Because of the way the auditor designed his or her audit, he or she may not detect a misstatement of $80,000, which is acceptable because the amount is not considered material. However, what if the auditor failed to detect 2 misstatements of $80,000? Individually, each misstatement would not be material, but when aggregated, the total misstatement is greater than materiality. Thus, materiality for the

financial statements as a whole would not be appropriate for assessing risk and performing further audit procedures at the assertion level.

.29 *Tolerable misstatement* (or *tolerable error*) is the maximum error in a population (for example, the class of transactions or account balance) that the auditor is willing to accept. Such levels of tolerable misstatement are normally lower than the materiality levels. Tolerable misstatement is the adjustment of financial statement materiality to the assertion level. This adjustment is necessary to make an allowance for misstatements that might arise in other accounts as well as make a provision for possible misstatements that might exist in the financial statements, but were not detected by the audit procedures. Tolerable misstatement effectively creates a margin for error in the auditor's audit plan to take into consideration misstatements that are not detected as part of the audit.

.30 For each class of transactions, account balance, and disclosure, the auditor should determine at least one level of tolerable misstatement. For example, if the auditor's overall financial statement materiality for audit planning purposes was $100,000, he or she might determine tolerable misstatement for testing receivables to be $70,000. Some firms use a guideline of, for example, 50 percent to 75 percent of materiality when setting tolerable misstatement at the account or detailed level for the average audit situation. Appendix L, "Matters to Consider in Determining Tolerable Misstatement," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* provides further guidance on this topic.

Qualitative Aspects of Materiality

.31 As indicated previously, judgments about materiality include both quantitative and qualitative information. As a result of the interaction of quantitative and qualitative considerations in materiality judgments, misstatements of relatively small amounts that come to the auditor's attention could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

.32 Qualitative considerations also influence the auditor in reaching a conclusion about whether misstatements are material. Paragraph .60 of AU section 312 provides qualitative factors that the auditor may consider relevant in determining whether misstatements are material.

Considerations as the Audit Progresses

.33 Because it is not feasible for the auditor to anticipate all the circumstances that may ultimately influence judgments about materiality in evaluating the audit findings at the completion of the audit, the auditor's judgment about materiality for planning purposes may differ from the judgment about materiality used in evaluating the audit findings.

.34 If the auditor concludes that a lower materiality level than that initially determined is appropriate, the auditor should reconsider the related levels of tolerable misstatement and appropriateness of the nature, timing, and extent of further audit procedures. The auditor should consider whether the overall audit strategy and audit plan need to be revised if the nature of identified misstatements and the circumstances of their occurrence are indicative that other misstatements may exist that, when aggregated with identified misstatements, could be material. The auditor should not assume that a misstatement is an isolated occurrence.

.35 If the aggregate of the misstatements (known and likely) that the auditor has identified approaches the materiality level, the auditor should consider whether there is a greater than acceptably low level of risk that undetected misstatements, when taken with the aggregate identified misstatements, could exceed the materiality level and, if so, the auditor should reconsider the nature and extent of further audit procedures.

Quantifying Materiality

.36 Although no authoritative body has established specific guidelines for materiality, certain rules of thumb can be used in making a preliminary assessment of materiality.

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.37 Generally, materiality guidelines are 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 determine what base to use. Generally, auditors select a base that is relatively stable and predictable. Bases commonly used include income before taxes, revenues, and total assets. Generally, misstatements become material to income before they become material to the balance sheet. As a consequence, net income before taxes is often selected as the base.

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

Example

.39 A common rule of thumb for materiality is 5 percent to 10 percent of pretax income (for profit-orientated entities). Some auditors apply this rule of thumb so that items less than 5 percent of normal pretax income are considered immaterial, whereas items that are more than 10 percent are material. For items between 5 percent to 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 percent and 10 percent as material. Others use 1 percent or 1.5 percent of the larger of total assets or revenues. (See exhibit 1 for a sample planning materiality worksheet.) Note that a percentage of pretax income may not be an appropriate benchmark for the determination of materiality when, for example, the entity's earnings are volatile, when the entity is a not-for-profit entity, or when the owner takes much of the pretax income out of the business in the form of remuneration.

Exhibit 1

	Initials	**Date**
Done	_______	_______
Reviewed	_______	_______

Client Name
Planning Materiality Worksheet
Balance Sheet Date

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

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

SEC Staff Bulletin on Materiality for SEC Registrants

.41 Securities and Exchange Commission (SEC) Staff Accounting Bulletin (SAB) No. 99, *Materiality*, addresses the application of materiality thresholds to the preparation and audit of financial statements filed with the SEC. The SAB does not create new standards or definitions for materiality, but reaffirms the concepts of materiality as expressed in the accounting and auditing literature, as well as in long standing case law.

.42 SAB No. 99 states that registrants and the auditors of their financial statements cannot rely exclusively on quantitative benchmarks to determine whether an item is material to the financial statements. Equally important is a consideration of whether, in light of the surrounding circumstances, a reasonable investor would consider the item to be important. The SAB also states that management should not make intentional immaterial errors in a registrant's financial statements to "manage" earnings. It further reminds registrants of their legal responsibility to make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect transactions and the disposition of assets. The SAB reminds auditors of their obligations to inform management and, in some cases, audit committees of illegal acts that come to the auditor's attention. The full text of the SAB can be viewed at the SEC website at www.sec.gov/interps/account/sab99.htm.

Communication of Misstatements to Management

.43 The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial,[2] and communicate them to the appropriate level of management. This communication should occur on a timely basis.

.44 When communicating details of misstatements, the auditor should distinguish between known misstatements and likely misstatements. The auditor should request management to record the adjustment needed to correct all known misstatements, including the effect of prior period misstatement, other than those that the auditor believes are trivial.

.45 If management decides not to correct some or all of the known and likely misstatements communicated to it by the auditor or identified when management examined a class of transactions, account balance, or disclosure, the auditor should obtain an understanding of management's reasons for not making the corrections and should take that into account when considering the qualitative aspects of the entity's accounting practices and the implications for the auditor's report.

Evaluating Audit Findings

.46 In evaluating whether the financial statements are presented fairly, in all material respects, in conformity with GAAP, the auditor must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. In making this evaluation, in relation to particular classes of transactions, account balances, and disclosures, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence and determine the effect of such misstatements on the financial statements taken as a whole.

.47 In aggregating misstatements, the auditor should include the effect on the current period's financial statements of those prior period misstatements. When evaluating the aggregate uncorrected misstatements, the auditor should consider the effects of these uncorrected misstatements in determining whether the financial statements are free of material misstatement.

[2] Matters that are "trivial" are amounts designated by the auditor below which misstatements need not be accumulated. This amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered.

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.48 In evaluating the effects of misstatements, the auditor should include both qualitative and quantitative materiality considerations (see paragraphs .59–.60 of AU section 312). Qualitative considerations also influence the auditor in reaching a conclusion regarding whether misstatements are material.

Likely Misstatements

.49 The auditor's best estimate of the total misstatements in the account balances or classes of transactions that he or she has examined is referred to as *likely misstatements*.

.50 When the auditor tests an account balance or a class of transactions and related assertions by an analytical procedure, he or she might not specifically identify misstatements but would only obtain an indication of whether a misstatement might exist in the balance or class and possibly its approximate magnitude. If the analytical procedure indicates that a misstatement might exist, but not its approximate amount, the auditor should request management to investigate and, if necessary, should expand his or her audit procedures to enable him or her to determine whether a misstatement exists in the account balance or class or transactions.

.51 When an auditor uses audit sampling to test an assertion for an account balance or a class of transactions, he or she projects the amount of known misstatements identified in the sample to the items in the balance or class from which the sample was selected. For example, if a $1,000 loan receivable misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $10,000. That projected misstatement, along with the results of other substantive procedures, contributes to the auditor's assessment of likely misstatement in the account balance or class of transactions.

.52 When auditing accounting estimates (for example, allowance for inventory obsolescence, allowance for doubtful accounts, or warranty obligations) the audit evidence gathered may support an amount for an estimate different from the amount the client has recorded. That difference may be considered reasonable by the auditor inasmuch as no one accounting estimate can be considered accurate with certainty. In that case, the difference between the estimate that the audit evidence supports and the estimate recorded in the financial statements would not be considered a likely misstatement. However, if the auditor believes the estimated amount included in the financial statements is unreasonable, he or she should treat the difference between that estimate and the closest reasonable estimate as a likely misstatement.

Known Misstatements

.53 *Known misstatements* are those for which the amount of the misstatements are specifically identified. Such misstatements are often supported by highly reliable evidence, such as third party documents. An example of a known misstatement would be a failure to record an invoice for repairs expense.

Misstatements From the Prior Year

.54 Often overlooked is the consideration of misstatements detected in the prior year that affect the current year. For example, assume last year's aggregation of uncorrected misstatements included an item representing an overstatement of prepaid insurance and an understatement of insurance expense. This item would be included in the current year's aggregation of uncorrected misstatements because it affects the current year's insurance expense. Therefore, the prior year's aggregation of uncorrected misstatements should be reviewed for any items that may have an effect on the current year's financial statements.

Summarizing and Evaluating Misstatements

.55 Most firms prepare a summary of the uncorrected misstatements identified during the audit. This summary may be called the *Summary of Misstatements*, or the *Summary of Possible Journal Entries*, or other names. The summary presents known, likely, and prior period misstatements separately. The summary is used in evaluating the effect of uncorrected misstatements on the financial statements at the end of the audit.

.56 Some firms establish a predetermined dollar threshold below which misstatements need not be accumulated. This amount may be set so that any such misstatements, either individually, or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered.

.57 When concluding whether the effect of misstatements, individually or in the aggregate, is material, an auditor should consider the nature and amount of the misstatements in relation to the nature and amount of items in the financial statements under audit.

.58 If the auditor believes that the financial statements taken as a whole are materially misstated, the auditor should request management to make the necessary corrections. If management refuses to make the corrections, the auditor must determine the implications for the auditor's report.

.59 If the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, they could still be materially misstated because of further misstatements remaining undetected. As the aggregate misstatements approach materiality, the risks that the financial statements may be materially misstated also increase; consequently, the auditor should also consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

Documentation

.60 In addition to the documentation requirements in AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), AU section 312 states the auditor should document the following:

a. The levels of materiality, as discussed in paragraph .27 of AU section 312, and tolerable misstatement, including any changes thereto, used in the audit and the basis on which those levels were determined

b. A summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements

c. The auditor's conclusion whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion

d. All known and likely misstatements identified by the auditor during the audit, other than those that are trivial, that have been corrected by management

.61 Uncorrected misstatements should be documented in a manner that allows the auditor to

a. separately consider the effects of known and likely misstatements, including uncorrected misstatements identified in prior periods.

b. consider the aggregate effect of misstatements on the financial statements.

c. consider the qualitative factors that are relevant to the auditor's consideration whether misstatements are material (see paragraph .60 of AU section 312).

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AAM Section 3145

Fraud

General

.01 AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*), states that "The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud." Management is responsible for the design and implementation of programs and controls to prevent, deter, and detect fraud. That responsibility is described in paragraph .03 of AU section 110.

.02 An auditor's responsibilities relating to fraud are stated within the context of materiality to the financial statements taken as a whole. An auditor is not responsible for detecting fraud per se, but for obtaining reasonable assurances that material misstatements due to fraud are detected. An auditor is not responsible for detecting immaterial misstatements caused by fraud. Paragraph .03 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), states that the requirements and guidance set forth in AU section 316 are intended to be integrated into the overall audit process in a logical manner that is consistent with the requirements and guidance provided in other AU sections, including AU section 311, *Planning and Supervision*; AU section 312, *Audit Risk and Materiality in Conducting and Audit*; AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, and AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*). AU section 316 describes a process in which the auditor

- exercises professional skepticism,
- discusses the risks of material misstatements due to fraud with engagement personnel,
- gathers information needed to identify risks of material misstatement due to fraud,
- identifies risks that may result in a material misstatement due to fraud,
- assesses the identified risks after taking into account an evaluation of the entity's programs and controls that address the risks,
- responds to the results of the assessment,
- evaluates audit evidence,
- communicates about fraud to management, those charged with governance, and others, and
- documents the auditor's consideration of fraud.

.03 Even though some requirements and guidance set forth in AU section 316 are presented in a manner that suggests a sequential audit process, auditing, in fact, involves a continuous process of gathering, updating, and analyzing information throughout the audit. Accordingly, the sequence of the requirements and guidance in AU section 316 may be implemented differently among audit engagements.

Description and Characteristics of Fraud

.04 The primary factor that distinguishes fraud from error is whether the underlying action that results in the misstatement in financial statements is intentional or unintentional. Paragraph .05 of AU section 316 defines fraud as an intentional act that results in a material misstatement in financial statements that are the subject of an audit.

.05 Three conditions generally are present when fraud occurs. First, management or other employees have an incentive or are under pressure, which provides a reason to commit fraud. Second, circumstances exist that provide an opportunity for a fraud to be perpetrated. Third, those involved are able to rationalize committing a fraudulent act.

Misstatements Arising From Fraudulent Financial Reporting

.06 Misstatements arising from fraudulent financial reporting are intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve acts such as the following:

- Manipulation, falsification, or alteration of accounting records or supporting documents from which financial statements are prepared
- Misrepresentation in, or intentional omission from, the financial statement of events, transactions, or other significant information
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure

Misstatements Arising From Misappropriation of Assets

.07 Misstatements arising from misappropriation of assets involve the theft of an entity's assets where the effect of the theft causes the financial statement not to be presented, in all material respects, in conformity with generally accepted accounting principles. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets, or causing an entity to pay for goods or services not received. Misappropriation of assets may be accomplished by false or misleading records or documents, possibly created by circumventing controls, and may involve one or more individuals among management, employees, or third parties.

The Importance of Exercising Professional Skepticism

.08 Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence, and requires an ongoing assessment of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred. The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity.

Discussion Among Engagement Personnel Regarding the Risks of Material Misstatement Due to Fraud

.09 Paragraph .14 of AU section 316 states that members of the audit team should discuss the potential for material misstatement due to fraud prior to or in conjunction with his or her information gathering procedures. The discussion should include the following:

- An exchange of ideas or brainstorming among the audit team members, including the auditor with final responsibility for the audit, about how and where they believe the entity's financial statements might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated
- An emphasis on the importance of maintaining the proper state of mind throughout the audit regarding the potential for material misstatement due to fraud

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As previously noted in section 3120, the brainstorming session to discuss the entity's susceptibility to material misstatements due to fraud could be held concurrently with the brainstorming session to discuss the potential of the risks of material misstatement that is required under AU section 314.

.10 Communication among the audit team members about the risks of material misstatement due to fraud should continue throughout the audit. See paragraphs .14–.18 of AU section 316 for further guidance.

Obtaining the Information Needed to Identify the Risks of Material Misstatement Due to Fraud

.11 In obtaining an understanding of the entity and its environment, including its internal control, information may come to the auditor's attention that should be considered in identifying risks of material misstatements due to fraud. The auditor should perform procedures to obtain information that is used to identify the risks of material misstatement due to fraud, including the following:

- Making inquiries of management and others within the entity to obtain their views about the risks of fraud and how they are addressed
- Considering any unusual or unexpected relationships that have been identified in performing analytical procedures in planning the audit
- Considering whether one or more fraud risk factors exist
- Considering other information that may be helpful in identifying risks of material misstatement due to fraud

See paragraphs .19–.34 of AU section 316 for further guidance.

.12 Although fraud usually is concealed and management's intent is difficult to determine, the presence of certain risk factors or other conditions may suggest to the possibility that fraud may exist. However, these conditions may be the result of circumstances other than fraud.

.13 The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by fraud or error. Because fraud is usually concealed, material misstatements due to fraud are difficult to detect. Nevertheless, the auditor may identify *fraud risk factors* that do not necessarily indicate the existence of fraud, but often are present in circumstances where fraud exists. A fraud risk factor is an event or condition that indicates the following:

- An incentive or pressure to perpetrate fraud
- Opportunities to carry out the fraud
- Attitudes or rationalizations to justify a fraudulent action

Identifying Risks That May Result in a Material Misstatement Due to Fraud[1]

.14 In identifying risks of material misstatement due to fraud, it is helpful for the auditor to consider the information that has been gathered in the context of the three conditions present when a material misstatement due to fraud occurs—that is, incentives and pressures, opportunities, and attitudes and rationalizations. However, the auditor should not assume that all three conditions must be observed or evident before concluding that there are identified risks.

[1] Paragraph .102 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA *Professional Standards*), states that the auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

.15 The identification of a risk of material misstatement due to fraud involves the application of professional judgment and includes the consideration of the attributes of the risk, including the following:

- The type of risk that may exist, that is, whether it involves fraudulent financial reporting or misappropriation of assets
- The significance of the risk, that is, whether it is of a magnitude that could lead to result in a possible material misstatement of the financial statements
- The likelihood of the risk, that is, the likelihood that it will result in a material misstatement in the financial statements
- The pervasiveness of the risk, that is, whether the potential risk is pervasive to the financial statements as a whole or specifically related to a particular assertion, account, or class of transactions

.16 Material misstatements due to fraudulent financial reporting often result from an overstatement or understatement of revenues. Therefore, the auditor should ordinarily presume that there is a risk of material misstatement due to fraud relating to revenue recognition. In addition, even if specific risks of material misstatement due to fraud are not identified by the auditor, there is a possibility that management override of controls could occur and, accordingly, the auditor should address that risk (see paragraph .57 of AU section 316) apart from any conclusions regarding the existence of more specifically identifiable risks.

Assessing the Identified Risks After Taking Into Account an Evaluation of the Entity's Programs and Controls That Address the Risks

.17 As part of the understanding of internal control sufficient to plan the audit required by AU section 314, the auditor should evaluate whether entity programs and controls that address identified risks of material misstatement due to fraud have been suitably designed and placed in operation and assess those risks taking into account that evaluation.

Responding to the Results of the Assessments[2]

.18 The auditor's response to the assessment of the risks of material misstatement due to fraud involves the application of professional skepticism in gathering and evaluating audit evidence and is influenced by the nature and significance of the risks identified as being present and the entity's programs and controls that address these identified risks. The auditor's response can be (1) an overall response on how the audit is conducted, (2) a response to identified risks involving the nature, timing, and extent of the auditing procedures to be performed, or (3) a response involving the performance of certain procedures to further address the risk of material misstatement due to fraud involving management override of controls, given the unpredictable ways in which such override could occur.

.19 The auditor may conclude that it would not be practicable to design auditing procedures that sufficiently address the risks of material misstatement due to fraud. In that case, withdrawal from the engagement with communication to the appropriate parties may be an appropriate course of action.

Overall Responses to the Risk of Material Misstatement

.20 Judgments about the risk of material misstatement due to fraud have an overall effect on how the audit is conducted in the following ways:

Assignment of personnel and supervision. The knowledge, skill, and ability of personnel assigned significant engagement responsibility should be commensurate with the auditor's assessment of the

[2] Paragraph .03 of AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), states that to reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. See paragraphs .04 and .07 of AU section 318. This requirement provides a link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks.

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risks of material misstatement due to fraud for the engagement. In addition, the extent of supervision should reflect the risks of material misstatement due to fraud.

Accounting principles. The auditor should consider management's selection and application of significant accounting principles, particularly those related to subjective measurements and complex transactions.

Predictability of auditing procedures. The auditor should incorporate an element of unpredictability in the selection from year to year of auditing procedures to be performed.

Responses Involving the Nature, Timing, and Extent of Procedures to Be Performed to Address the Identified Risks

.21 The auditing procedures performed in response to identified risks of material misstatement due to fraud will vary depending on the types of risks identified and the account balances, classes of transactions, and related assertions that may be affected. These procedures may involve both substantive tests and tests of the operating effectiveness of the entity's programs and controls. The auditor's responses to address specifically identified risks of material misstatement due to fraud may include changing the nature, timing, and extent of auditing procedures. See paragraphs .52–.56 of AU section 316 for more guidance.

Responses to Further Address the Risk of Management Override of Controls

.22 Management is in a unique position to perpetrate fraud because of its ability to directly or indirectly manipulate accounting records and prepare fraudulent financial statements by overriding established controls that otherwise appear to be operating effectively. Accordingly, in addition to overall responses and responses that address specifically identified risks of material misstatement due to fraud, certain procedures should be performed to further address the risk of management override of controls, as discussed in paragraphs .58–.67 of AU section 316.

Evaluating Audit Evidence

.23 The auditor's assessment of the risks of material misstatement due to fraud should be ongoing throughout the audit. The auditor should consider whether analytical procedures performed in planning the audit result in identifying any unusual or unexpected relationships that should be considered in assessing the risks of material misstatements due to fraud. The auditor also should evaluate whether analytical procedure that were performed as substantive tests or in the overall review stage of the audit indicate a previously unrecognized risk of material misstatement due to fraud.

.24 At or near the completion of fieldwork, the auditor should evaluate whether the accumulated results of audit procedures and other observations affect the assessment of the risks of material misstatement due to fraud made earlier in the audit. Such an evaluation may provide further insight into the risks of material misstatement due to fraud and whether there is a need for additional or different audit procedures to be performed.

.25 When audit test results identify misstatements in the financial statements, the auditor should consider whether such misstatements may be indicative of fraud. If the auditor has determined that misstatements are or may be the result of fraud, but the effect of the misstatements is not material, the auditor, nevertheless, should evaluate the implications, especially those dealing with the organizational position of the person(s) involved. If the matter involves higher level management, even though the amount itself is not material to the financial statements, it may be indicative of a more pervasive problem, for example, implications about the integrity of management. In such circumstances, the auditor should reevaluate the assessment of the risk of material misstatement due to fraud and its resulting impact on (*a*) the nature, timing, and extent of the tests

of balances or transactions and (*b*) the assessment of the effectiveness of controls if control risk was assessed below the maximum.

.26 If the auditor believes that the misstatement is, or may be, the result of fraud, and either has determined that the effect could be material to the financial statements or has been unable to evaluate whether the effect is material, the auditor should

- attempt to obtain additional audit evidence to determine whether material fraud has occurred or is likely to have occurred and, if so, its effect on the financial statements and the auditor's report thereon;
- discuss the matter and the approach for further investigation with an appropriate level of management that is at least one level above those involved, and with senior management and those charged with governance;
- consider the implications for other aspects of the audit; and
- if appropriate, suggest that the client consult with legal counsel.

.27 The auditor's consideration of the risks of material misstatement and the results of audit tests may indicate such a significant risk of material misstatement due to fraud that the auditor should consider withdrawing from the engagement and communicating the reasons for withdrawal to those charged with governance or others with equivalent authority and responsibility. Whether the auditor concludes that withdrawal from the engagement is appropriate may depend on (*a*) the implications about the integrity of management and (*b*) the diligence and cooperation of management or the board of directors in investigating the circumstances and taking appropriate action. Because of the variety of circumstances that may arise, it is not always possible to definitely describe when withdrawal is appropriate. The auditor may wish to consult with legal counsel when considering withdrawal from an engagement.

Communicating About Possible Fraud to Management, Those Charged With Governance, and Others

.28 Whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements should be reported directly to those charged with governance. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with the committee about misappropriations perpetrated by lower level employees.

.29 If the auditor, as a result of the assessment of the risks of material misstatement, has identified risks of material misstatement due to fraud that have continuing control implications (whether or not transactions or adjustments that could be the result of fraud have been detected) the auditor should consider whether these risks represent significant deficiencies or material weaknesses in the entity's internal control that should be communicated to management and those charged with governance. Also the auditor should consider whether the absence of or deficiencies in programs and controls to mitigate specific risks of fraud or to otherwise help prevent, deter, and detect fraud represent significant deficiencies or material weaknesses that should be communicated to management and those charged with governance.

.30 The auditor should recognize that in the following circumstances a duty to disclose outside the entity may exist

- to comply with certain legal and regulatory requirements.
- to a successor auditor when the successor makes inquiries in accordance with AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*).
- in response to a subpoena.

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- to a funding agency or other specified agency in accordance with requirements for the audits of entities that receive governmental financial assistance.

Because potential conflicts with the auditor's ethical and legal obligations for confidentiality of client matters may be complex, the auditor may wish to consult with legal counsel before discussing matters of fraud or possible fraud with parties outside the client.

Documenting the Auditor's Consideration of Fraud

.31 The auditor should document the following:

- The discussion among engagement personnel in planning the audit regarding the susceptibility of the entity's financial statements to material misstatement due to fraud, including how and when the discussion occurred, the audit team members who participated, and the subject matter discussed
- The procedures performed to obtain information necessary to identify and assess the risks of material misstatement due to fraud
- Specific risks of material misstatement due to fraud that were identified and a description of the auditor's response to those risks
- If the auditor has not identified, in a particular circumstance, improper revenue recognition as a risk of material misstatement due to fraud, the reasons supporting the auditor's conclusion
- The results of the procedures performed to further address the risk of management override of controls
- Other conditions and analytical relationships that caused the auditor to believe that additional auditing procedures or other responses were required and any further responses the auditor concluded were appropriate, to address such risks or other conditions

The nature of the communications about fraud made to management, those charged with governance, and others.

Fraud Risk Factor Memory Jogger

.32 An auditor may find this memory jogger helpful during planning and at other stages of the audit, when considering fraud risk factors and assessing the risks of material misstatement due to fraud. The following listing contains example risk factors for small, privately owned businesses. If used, this memory jogger should be tailored for the particular client being audited. Identified or possible risk factors should be added to the list. An auditor may also decide to remove the example factors from the list based on the circumstances. In any event, be sure to consider fraud risk factors that relate to fraudulent financial reporting and misappropriation of assets in every related category presented. An auditor should feel free to use this practice aid as he or she sees fit (for example, adding attachments, redesigning the form of the memory jogger). Finally, note that AU section 316 does not require an auditor to use a memory jogger or checklist of fraud risk factors.

Part 1—Fraudulent Financial Reporting

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[3]	*Audit response documented? (W/P Ref.)*[4]	*Additional information*
A. Incentives and Pressures				
1. Financial stability or profitability is threatened by economic, industry, or entity operating conditions, such as (or as indicated by) the following:				
a. High degree of competition or market saturation, accompanied by declining margins				
b. New accounting, statutory, or regulatory requirements				
c. Significant declines in customer demand and increasing business failures in either the industry or the economy in which the entity operates				
d. High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates				
e. Operating losses making the threat of bankruptcy or foreclosure, imminent				
f. Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth				
g. Rapid growth or unusual profitability especially compared to that of other companies in the same industry				
2. Excessive pressure exists for management to meet the requirements or expectations of third parties due to the following:				
a. Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures				
b. Marginal ability to meet debt repayment or other debt covenant requirements				
3. Management's personal net wealth is threatened by the entity's financial performance arising from the following:				
a. Heavy concentrations of their personal net worth in the entity.				

[3] Based on the assessment of risk of material misstatement due to fraud, an auditor may respond to identified risk factors individually or in combination.

[4] The auditor's response to identified risk factors should be documented. Documentation should be maintained at a place in the working papers considered most suitable, depending upon the type of risk factor and the type of response. Generally, if a response is specific to a particular account balance or class of transactions, documentation of the audit procedures would be placed in the appropriate audit program (for example, cash investments). If it is determined that audit procedures already planned or normally carried out are a sufficient response to the identified risk factor, that fact should be documented.

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Fraud risk factors considered	*Present at client?*	*Audit response developed?*[3]	*Audit response documented? (W/P Ref.)*[4]	*Additional information*
b. Personal guarantees of debt of the entity that are significant to their personal net worth.				
c. Adverse consequences on significant matters if *good* financial results are reported. Specific examples include management's motivation to inappropriately reduce income taxes, to defraud a divorced spouse or a partner of his or her share of the profits or assets of a business, or to convince a judge or arbitrator that the business in dispute is not capable of providing adequate cash flow. Keep in mind that you are not required to plan your audit to discover personal information (for example, marital status) of the owner-manager. However, if you become aware of such information, you may consider it in your assessment of risk of material misstatement due to fraud.				
4. There is excessive pressure on management or operating personnel to meet financial targets set by the owner, including sales or profitability incentive goals.				
B. Opportunities				
1. The nature of the industry or the entity's operations provides opportunities to engage in fraudulent financial reporting that can arise from the following:				
a. Significant related party transactions not in the ordinary course of business or with related entities not audited or audited by another firm				
b. Assets, liabilities, revenues, or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate				
c. Significant, unusual, or highly complex transactions, especially those close to year-end that pose difficult "substance over form" questions				
2. There is a complex or unstable organizational structure as evidenced by the following:				
a. Difficulty in determining the organization or individuals that have controlling interest in the entity				
b. Overly complex organizational structure involving unusual legal entities or managerial lines of authority				
c. High turnover of senior management or counsel				
3. Internal control components are deficient as a result of the following:				
a. Inadequate monitoring of controls, including automated controls				

(continued)

Fraud risk factors considered	*Present at client?*	*Audit response developed?*[3]	*Audit response documented? (W/P Ref.)*[4]	*Additional information*
b. High turnover rates or employment of ineffective accounting staff.				
c. Ineffective accounting and information systems including situations involving reportable conditions				
C. Attitudes and Rationalizations				
1. A failure for management to display and communicate an appropriate attitude regarding internal control and the financial reporting process				
2. Ineffective communication and support of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards				
3. Nonfinancial management's excessive participation in or preoccupation with the selection of accounting principles or the determination of significant estimates				
4. Known history of violations or claims against the entity, its owner or senior management alleging fraud or violations of laws and regulations				
5. A practice by management of committing to creditors and other third parties to achieve aggressive or unrealistic forecasts				
6. Management failing to correct known reportable conditions on a timely basis				
7. An interest by management in employing inappropriate means to minimize reported earnings for tax motivated reasons				
8. Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality				
9. The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:				
a. Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters				
b. Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report				
c. Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with the board of directors or those charged with governance				
d. Domineering management behavior in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of audit personnel assigned to the engagement				

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Part 2—Misappropriation of Assets

A. Incentives and Pressures				
1. Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.				
2. Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft may motivate those employees to misappropriate those assets. For example, adverse relationships may be created by the following:				
a. Known or anticipated future layoffs				
b. Promotions, compensation, or other rewards inconsistent with expectations				
B. Opportunities				
1. Certain characteristics or circumstances may increase the susceptibility of assets to misappropriation. For example, opportunities to misappropriate assets increase when there are the following:				
a. Large amounts of cash on hand or processed				
b. Company issued credit cards				
c. Inventory items that are small in size, of high value, or in high demand				
d. Easily convertible assets				
e. Fixed assets, that, are small in size, marketable, or lacking observable identification of ownership				
2. Inadequate internal control over assets may increase the susceptibility of misappropriation of those assets. For example, misappropriation of assets may occur because there is the following:				
a. Inadequate segregation of duties or independent checks. Inadequate segregation of duties is quite often understandable in a small business environment in that it's a function of the entity's size. However, you may consider it in conjunction with other risk factors and with mitigating controls.				
b. Inadequate management oversight of employees responsible for assets.				
c. Inadequate job applicant screening of employees with access to assets.				
d. Inadequate record keeping with respect to assets.				

(continued)

e. Inadequate system of authorization and approval of transactions (for example, in purchasing).				
f. Inadequate physical safeguards over cash, investments, inventory, or fixed assets.				
g. Lack of timely and appropriate documentation of transactions, for example, credits for merchandise returns.				
h. Lack of mandatory vacations for employees performing key control functions.				
i. Inadequate management understanding of information technology, which enables information technology employees to perpetrate a misappropriation.				
j. Inadequate access controls over automated records.				
C. Attitudes and Rationalizations				
1. Disregard for the need for monitoring or reducing risks related to misappropriations of assets				
2. Disregard for internal control over misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies				
3. Behavior indicating displeasure or dissatisfaction with the company or its treatment of the employee				
4. Changes in behavior or lifestyle that may indicate assets have been misappropriated				

[*The next page is 3311.*]

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AAM Section 3150

Illegal Acts

General Comments

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

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

Direct and Material Effect Illegal Acts

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

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

.05 The auditor's responsibility to detect and report misstatement resulting from illegal acts having a direct and material effect on the determination of financial statement amounts is the same as that for errors or fraud as described in AU section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*). That is, the auditor should design the audit to provide reasonable assurance that financial statement amounts are free from material misstatement resulting from these direct-effect illegal acts.

Other Illegal Acts

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

.07 An auditor ordinarily does not have sufficient basis for recognizing possible violations of such laws and regulations. Their indirect effect is normally the result of the need to disclose a contingent liability because of the allegation or determination of illegality. Normally, an audit conducted in accordance with generally accepted auditing standards does not include audit procedures specifically designed to detect illegal acts having an indirect effect on financial statements.

Engagement Planning Procedures

.08 The auditor should assess the risks that the entity has not complied with laws and regulations that 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 the following:

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

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

c. Changes in requirements since the last audit

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

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

.10 Normally, there is no need to include audit procedures specifically designed to detect illegal acts. However, if the auditor becomes aware of information that raises suspicions, he or she is obligated to apply additional procedures to determine whether an illegal act has, in fact, occurred (see paragraphs .07–.11 of AU section 317, *Illegal Acts by Clients* [AICPA, *Professional Standards*]).

[*The next page is 3331.*]

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AAM Section 3155

Analytical Procedures

General Comments

.01 Analytical procedures are a natural extension of the auditor's understanding of the client's business and add to his or her understanding because the key factors that influence the client's business may be expected to affect the client's financial information. Analytical procedures are used in all three stages of the audit. In the planning stage, the purpose of analytical procedures is to assist in planning the nature, timing, and extent of auditing procedures that will be used to obtain audit evidence for specific account balances or classes of transactions.[1] In the substantive testing stage of the audit, the purpose of analytical procedures is to obtain evidence, sometimes in combination with other substantive procedures, to identify misstatements in account balances and, thus, to reduce the risk that misstatements will remain undetected. The auditor's reliance on substantive tests to achieve an audit objective related to a particular assertion may be derived from tests of details, from analytical procedures, or from a combination of both. The decision about which procedure or procedures to use to achieve a particular audit objective is based on the auditor's judgment about the expected effectiveness and efficiency of the available procedures. In the overall review stage, the objective of analytical procedures is to assist the auditor in assessing the conclusions reached and in evaluating the overall financial statement presentation. In all cases, the effectiveness of analytical procedures lies in developing expectations that can reasonably be expected to identify unexpected relationships.

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

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

Analytical Procedures

.03 *Analytical procedures* are defined in paragraph .02 of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. ... A basic premise underlying the application of analytical procedures is that plausible relationships among data may reasonably be expected to exist and continue in the absence of conditions to the contrary." The definition implies several key concepts:

- The "evaluations of financial information" suggests that analytical procedures will be used to understand or test financial statement relationships or balances.
- The "study of plausible relationships" implies an understanding of what can reasonably be expected and involves a comparison of the recorded book values with an auditor's expectations.
- "Relationships among both financial and nonfinancial data" suggests that both types of data can be useful in understanding the relationships of the financial information and, therefore, in forming an expectation.

[1] In accordance with paragraph .06 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), analytical procedures are also performed as risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control. Refer to AU section 314 for further guidance.

.04 Also, in accordance with paragraph .09 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor should apply analytical procedures in planning the audit to assist in understanding the entity and its environment and to identify areas that may represent specific risks relevant to the audit. For example, analytical procedures may be helpful in identifying the existence of unusual transactions or events and amounts, ratios, and trends that might indicate matters that have financial statement and audit implications. In performing analytical procedures as risk assessment procedures, the auditor should develop expectations about plausible relationships that are reasonably expected to exist. When comparison of those expectations with recorded amounts or ratios developed from recorded amounts yields unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement. However, when such analytical procedures use data aggregated at a high level (which is often the situation), the results of those analytical procedures provide only a broad initial indication about whether a material misstatement may exist. Accordingly, the auditor should consider the results of such analytical procedures along with other information gathered in identifying the risks of material misstatement.

.05 Analytical procedures performed during the overall review stage are designed to assist the auditor in assessing that (*a*) all significant fluctuations and other unusual items have been adequately explained and (*b*) the overall financial statement presentation makes sense based on the audit results and the auditor's knowledge of the business.

.06 During the substantive testing stage, analytical procedures may be used to obtain assurance that material misstatements are not likely to exist in financial statement account balances. If analytical procedures are used for substantive testing, the auditor should focus his or her analytical procedures on particular assertions about account balances and should give detailed attention to the underlying factors that affect those account balances through the development of an expectation independent of the recorded balance. Therefore, substantive analytical procedures generally are performed with more rigor and precision than those used for planning or overall review.

.07 AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), establishes requirements and provides guidance on the use of analytical procedures as substantive procedures. In designing substantive analytical procedures, the auditor should consider such matters as the following:

- The suitability of using substantive analytical procedures, given the assertions
- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed
- Whether the expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance
- The amount of any difference in recorded amounts from expected values that is acceptable

The auditor should consider testing the controls, if any, over the entity's preparation of information to be used by the auditor in applying analytical procedures. When such controls are effective, the auditor has greater confidence in the reliability of the information and, therefore, in the results of analytical procedures. When designing substantive analytical procedures, the auditor should evaluate the risk of management override of controls. As part of this process, the auditor should evaluate whether such an override might have allowed adjustments outside of the normal period-end financial reporting process to have been made to the financial statements. Such adjustments might have resulted in artificial changes to the financial statement relationships being analyzed, causing the auditor to draw erroneous conclusions. For this reason, substantive analytical procedures alone are not well suited to detecting some types of fraud. Alternatively, the auditor may consider whether the information was subjected to audit testing in the current or prior period. In determining the audit procedures to apply to the information upon which the expectation for substantive analytical procedures is based, the auditor should consider the guidance in paragraph .14 of AU section 318.

.08 In planning substantive analytical procedures, the auditor should consider the amount of difference from the expectation that can be accepted without further investigation. This consideration is influenced

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primarily by tolerable misstatement and should be consistent with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. In designing substantive analytical procedures, the auditor should increase the desired level of assurance as the risk of material misstatement increases.

Analytical Procedure Process: Four Phases

.09 The use of analytical procedures can be considered a process that consists of four phases. The first phase is the expectation-formation process. In this phase, the auditor forms an expectation of an account balance or financial relationship. In doing so, the auditor determines the precision of the expectation and, thus, in part, the effectiveness of the analytical procedure.

.10 The remaining three phases consist of the identification, investigation, and evaluation of the difference between the auditor's expected value and the recorded book value in light of the auditor's materiality assessment. In the second phase, identification, the auditor identifies whether an unusual fluctuation exists between the expected and recorded amounts. In the third, investigation, the auditor investigates the cause of unexpected differences by considering possible causes and searching for information to identify the most probable causes. Finally, in the evaluation phase, the auditor evaluates the likelihood of material misstatement and determines the nature and extent of any additional auditing procedures that may be required.

Expectation Formation (Phase I)

.11 Forming an expectation is the most important phase of the analytical procedure process. The more precise the expectation (that is, the closer the auditor's expectation is to the correct balance or relationship), the more effective the procedure will be at identifying potential misstatements. Also, AU section 329 states that the expectation should be precise enough to provide the desired level of assurance that differences that may be potential misstatements, individually or when aggregated with other misstatements, would be identified for the auditor to investigate.

.12 The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:

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

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

c. Relationships among elements of financial information within the period

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

e. Relationships of financial information with relevant nonfinancial information

.13 The effectiveness of an analytical procedure is a function of three factors related to the precision with which the expectation is developed: (*a*) the nature of the account or assertion, (*b*) the reliability and other characteristics of the data, and (*c*) the inherent precision of the expectation method used.

Identification and Investigation (Phases II and III)

.14 The next two phases of the analytical procedure process consist of identification and investigation. Identification begins by comparing the auditor's expected value with the recorded amount. Given that the auditor developed an expectation with a particular amount of difference that could be accepted without further explanation, he or she then compares the unexpected differences with the threshold. In substantive testing, an auditor testing for the possible misstatement of the book value of an account determines whether

the audit difference was less than the auditor's threshold. If the difference is less than the acceptable threshold, taking into consideration the desired level of assurance from the procedure, the auditor accepts the book value without further investigation. If the difference is greater, the next step is to investigate the difference.

.15 In investigation, the auditor should evaluate possible explanations for the difference. The greater the precision of the expectation (that is, the closer the expectation is to the correct amount) the greater the likelihood that the difference between the expected and recorded amounts is due to misstatement rather than nonmisstatement causes. The difference between an auditor's expectation and the recorded book value of an account (value of an account not subject to auditing procedures) can be due to any or all of the following three causes: (*a*) the difference is due to misstatements, (*b*) the difference is due to inherent factors that affect the account being audited (for example, the predictability of the account or account subjectivity), and (*c*) the difference is due to factors related to the reliability of data used to develop the expectation (for example, data that have been subject to auditing procedures versus data that have not been subject to auditing procedures). The greater the precision of the expectation, the more likely the difference between the auditor's expectation and the recorded value will be due to misstatements (cause [*a*]). Conversely, the less precise the expectation, the more likely the difference is due to factors related to the precision of the expectation (causes [*b*] and [*c*]).

Evaluation (Phase IV)

.16 The final phase of the analytical procedure process consists of evaluating the difference between the auditor's expected value and the recorded amount. It is usually not practicable to identify factors that explain the exact amount of a difference identified for investigation. However, the auditor should attempt to quantify that portion of the difference for which plausible explanations can be obtained and, where appropriate, corroborated and determine that the amount that cannot be explained is sufficiently small to enable him or her to conclude on the absence of material misstatement.

.17 If a reasonable explanation can not be obtained, in accordance with paragraph .50 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), the auditor must consider the effects, both individually and in the aggregate, of misstatements (known and likely) that are not corrected by the entity. In making this evaluation, in relation to particular classes of transactions, account balances, and disclosures, the auditor should consider the size and nature of the misstatements and the particular circumstances of their occurrence and determine the effect of such misstatements on the financial statements taken as a whole. Misstatements should be aggregated in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole." In this case, the auditor should aggregate the misstatement, depending on materiality considerations, with other misstatements the entity has not corrected in the manner discussed in AU section 312.

Engagement Planning Procedures

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

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

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analytical procedures, combined with the auditor's knowledge of the business, serve as a basis for additional inquiries and effective planning.

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

Audit Documentation Requirements

.21 Paragraph .22 of AU section 329 states than when an analytical procedure is used as the principal substantive test of a significant financial statement assertion the auditor should document all of the following:

- The expectation, where that expectation is not otherwise readily determinable from the documentation of the work performed, and factors considered in its development
- Results of the comparison of the expectation to the recorded amounts or ratios developed from the recorded amounts
- Any additional auditing procedures performed in response to significant unexpected differences arising from the analytical procedure and the results of such additional procedures

Analytical Procedures Audit Guide

.22 For additional guidance, practitioners may refer to the AICPA Audit Guide *Analytical Procedures*. The guide provides practical guidance for auditors on the effective use of analytical procedures. Specifically, the audit guide includes a discussion of AU section 329; concepts and definitions; a series of questions and answers, grouped in the following five categories: precision of the expectation, relationship of analytical procedures to the audit risk model, evaluation and investigation, purpose of analytical procedures, and fraud; and a case study illustrating the four types of expectation methods discussed in chapter 1 of the guide: trend analysis, ratio analysis, reasonableness testing, and regression analysis.

.23 Audit Guide *Analytical Procedures* also includes illustrations that demonstrate the importance of forming expectations and considering the precision of the expectation, two of the most misunderstood concepts from AU section 329. The concepts discussed are applicable for all three stages of the audit (planning, substantive testing, and review). However, the guide focuses principally on how the concepts are applied to substantive testing because in designing substantive procedures, auditors ordinarily desire a specified level of audit assurance. To obtain the Audit Guide, call the AICPA order department at (888) 777-7077 and ask for product no. 012558 or visit www.cpa2biz.com and search for the aforementioned product number.

[*The next page is 3361.*]

AAM Section 3160

Audit Assignment Controls

.01

Audit Time Budget — Sample A

Client ______________________ Audit date ______________________

Prepared by ______________________

Approved:

Supervisor ______________ Date ____________ Partner ______________ Date ____________

Preliminary work: Start ____________ End ____________

Final work: Start ____________ End ____________

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

(Excludes tax and report departments' time)

.02

Audit Time Budget — Sample B

Date	Total hours (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 companion	Transactions since balance-sheet date	Preparation of reports	Internal control quest. and mgmt. letter	Time summary	Supervision	Correspondence and conferences	Review in-house computer programs	Audit of / with computer	General ledger and journal entries	In banks and on hand	Receipts and disbursements	Notes/accts. rec. and allowance for losses	Observation	Comparison of quantities	Valuation	Clerical accuracy and analytical review	Prepaid expenses	Other current assets	Fixed assets and depreciation	Investments	Other assets	Notes payable and long-term debt	Accounts payable	Other current liabilities	Other long-term liabilities and deferred income	Stockholders equity	Contingent liabilities	Sales and revenue	Payrolls	Other expense and income tests and analyses	Preparation of tax returns			
Budget																																												
Actual																																												

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.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																																				

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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

Weekly Progress Report

Date ______________

Supervisor

_________________________________ In-charge auditor ______________________

Client

_____________________________________ Case ____________________________________

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

[*The next page is 3401.*]

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AAM Section 3165

Sample Engagement Letters

.01 Following are illustrative engagement letters. These illustrative letters are examples and may not include all representations necessary for a particular engagement. They may be used as a starting point in the design of specific letters and then tailored to satisfy the terms of a particular engagement. These illustrative engagement letters are intended to be used in connection with engagements of nonpublic entities and are not intended to be used in connection with audits of public entities that are required to be audited under standards set by the Public Company Accounting Oversight Board.

.02 Audit Engagement Leading to Opinion

LACKO, LYNCH, BROWN & COMPANY — Certified Public Accountants

[*Date*]
Mr. Matt Decker, President
Civil War Antiques, Inc.
111 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Decker:

This will confirm our understanding of the services we will provide to Civil War Antiques, Inc. (the Company) for the year ending December 31, 20XX.

We will audit the balance sheet of Civil War Antiques, Inc. as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended, for the purpose of expressing an opinion on them.

Audit Objective

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

Audit Procedures

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by errors or fraud. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come

to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.[1]

Our procedures will include tests of transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected customers, creditors, legal counsel, and financial institutions. At the conclusion of our audit, we will request certain written representations (a "representation letter") from you about the financial statements and related matters.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements, or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

An audit includes obtaining an understanding of the entity and its environment, including its internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards.

Management Responsibilities

The Company's management is responsible for the basic financial statements and all accompanying information as well as all assertions contained therein. Encompassed in that responsibility are the establishment and maintenance of effective internal control over financial reporting; the establishment and maintenance of proper accounting records; the selection of appropriate accounting principles; the safeguarding of assets; fair presentation of the financial statements with accounting principles generally accepted in the United States of America; and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us and for the accuracy and completeness of that information.

The Company's management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

The Company's management is responsible for the design and implementation of programs and controls to prevent and detect fraud and for informing us about all known or suspected fraud or illegal acts affecting the Company involving management, employees who have significant roles in internal control, and others where the fraud or illegal acts could have a material effect on the financial statements. Management's responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud or illegal acts affecting the Company received in communications from employees, former employees, regulators, or others. In

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[1] Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics Ruling No. 94, "Indemnification Clause in Engagement Letters," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 191 par. .188–.189), states that the following indemnification clause in an engagement letter would not impair a CPA's independence: The client agrees to release, indemnify, and holds me (us) (and my (our) partners and our heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Auditors of publicly held companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter. Note that the AICPA Professional Ethics Executive Committee (PEEC) is currently addressing the issue of indemnification clauses.

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addition, the Company's management is responsible for identifying and ensuring that the Corporation complies with applicable laws and regulations and for taking timely and appropriate steps to remedy any fraud, illegal acts, or violations of contracts or grant agreements, or abuse that we may report.

Management is responsible for making all management decisions and performing all management functions, for designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other nonattest services we provide, and for evaluating the adequacy and results of those services and accepting responsibility for them.

Other Engagement Matters and Limitations

As part of our engagement for the year ending December 31, 20XX, we will review the federal and state income tax returns for Civil War Antiques, Inc. Further, we will be available during the year to consult with you on the tax effects of any proposed transactions or contemplated changes in business policies.

Professional standards require us to be independent with respect to the Company in the performance of our services. Any discussions that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual's base compensation at the Company, [xx] days from the first day of employment.

Audit Administration, Fees, and Other

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.[2]

Auditing standards generally accepted in the United States of America require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant findings from the audit, including, among others: (*a*) the initial selection of and changes in significant accounting policies and their application; (*b*) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (*c*) significant difficulties that we encountered in dealing with management related to the performance of the audit; (*d*) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (*e*) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (*f*) management representations; (*g*) our views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters; (*h*) major issues that were discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions

[2] Ethics Ruling No. 112, "Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services," under Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, ET sec. 191 par. .224–.225), requires that clients be informed if the firm will outsource professional services to third party service providers. If an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.

indicating there could be a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

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

Our fees will be billed as work progresses and are based on the amount of time required plus out of pocket costs and administrative expenses. Invoices are payable upon presentation. Our initial fee estimate assumes we will receive the aforementioned assistance from your personnel and unexpected circumstances will not be encountered. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees, which we estimate to range from $XX,XXX to $XX,XXX. Additional expenses are expected to be $X,XXX.

The audit documentation for this engagement is the property of Lacko, Lynch, Brown & Company and constitutes confidential information. However, we may be requested to make certain audit documentation available to ______________________ [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of Lacko, Lynch, Brown & Company personnel. Furthermore, upon request, we may provide photocopies of selected audit documentation to ______________________________ [*name of regulator*]. The ____________________ [*name of regulator*] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one. If you have any questions, please contact us. If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

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[*Engagement Partner's Signature*]

Accepted and agreed to:

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[*Client Representative's Signature*]

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[*Title*]

____

[*Date*]

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

MACARTHUR & KENNEY, CPA'S — Certified Public Accountants

[*Date*]
Mr. James Melakon, Treasurer
Nimbus Country Club
64 Vasily Road
Velikiye Luki, Ohio 10000

Dear Mr. Melakon:

As we agreed in our original engagement letter dated [*date*] we are notifying you that our audit of your December 31, 20XX financial statements requires additional procedures.

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

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

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

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

Very truly yours,

MACARTHUR & KENNEY, CPA'S

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[*Engagement Partner's Signature*]

Accepted and agreed to:

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[*Client Representative's Signature*]

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[*Title*]

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[*Date*]

.04 Conditions Encountered That Do Not Permit Expression of Opinion as Anticipated in Original Engagement Letter

GEROW, COLLINS & PATCH — Certified Public Accountants

[*Date*]
Mrs. Helene Daestrom, President
Cohrane Manufacturing, Inc.
1234 West Street
Cedar Hill, Tennessee 10000

Dear Mrs. Daestrom:

Our March 15, 20XX letter described our present engagement as an audit for the purpose of expressing an opinion on the financial statements based on our audit. This letter is to inform you that because of the circumstances described below, we will be required to qualify our opinion on these statements.

As you know, the Internal Revenue Service has proposed total income tax assessments of approximately $XXX,XXX for the three fiscal years ended December 31, 20XX. Your tax counsel has advised us that although you have a defensible position and will protest the assessments, counsel cannot offer an opinion as to your ultimate liability. No provision for this assessment or any portion of it is included in your December 31, 20XX financial statements, nor do you feel any is necessary.

Due to an inability to obtain sufficient appropriate audit evidence to support your assertions regarding the tax assessment situation described above, we will be unable to express an unqualified opinion. Our report will state the reasons for the qualification of our opinion.

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

Sincerely,

GEROW, COLLINS & PATCH

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[*Engagement Partner's Signature*]

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

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.05 Audit of Not-for-Profit Financial Statements

LACKO, LYNCH, BROWN & COMPANY Certified Public Accountants

[*Date*]
Mr. Matt Smith, President
Not-for-Profit Entity
222 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Smith:

This will confirm our understanding of the services we will provide to Not-for-Profit Entity (the Entity) for the year ending December 31, 20XX.

We will audit the statement of financial position of Not-for-Profit Entity as of December 31, 20XX, and the related statements of activities and cash flows for the year then ended, for the purpose of expressing an opinion on them.[3]

Audit Objective

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

Audit Procedures

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from errors or fraud. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.[4]

Our procedures will include tests of transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected individuals, funding sources, creditors, legal counsel, and financial institutions. At the conclusion of our audit, we will request certain written representations (a "representation letter") from you about the financial statements and related matters.

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[3] According to Financial Accounting Standards Board *Accounting Standards Codification* 958-205-45-4, a voluntary health and welfare entity should provide a statement of functional expenses.

[4] Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics Ruling No. 94 under Rule 101 (AICPA, *Professional Standards*, ET sec. 191 par. .188–.189) states that the following indemnification clause in an engagement letter would not impair a CPA's independence: The client agrees to release, indemnify, and holds me (us) (and my (our) partners and our heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Auditors of publicly held companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter. Note that the AICPA PEEC is currently addressing the issue of indemnification clauses.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements, or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

An audit includes obtaining an understanding of the Entity and its environment, including its internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards.

Management Responsibilities

The Entity's management is responsible for the basic financial statements and all accompanying information as well as all assertions contained therein. Encompassed in that responsibility are the establishment and maintenance of effective internal control over financial reporting; the establishment and maintenance of proper accounting records; the selection of appropriate accounting principles; the safeguarding of assets; fair presentation of the financial statements with accounting principles generally accepted in the United States of America; and compliance with relevant laws and regulations. Management is also responsible for making all financial records and related information available to us and for the accuracy and completeness of that information.

The Entity's management is responsible for adjusting the financial statements to correct material misstatements and for affirming to us in the representation letter that the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

The Entity's management is responsible for the design and implementation of programs and controls to prevent and detect fraud and for informing us about all known or suspected fraud affecting the Entity involving management, employees who have significant roles in internal control, and others where the fraud could have a material effect on the financial statements. Management's responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud affecting the Entity received in communications from employees, former employees, regulators, or others. In addition, the Entity's management is responsible for identifying and ensuring that the Entity complies with applicable laws and regulations and for taking timely and appropriate steps to remedy any fraud, illegal acts, or violations of contracts or grant agreements, or abuse that we may report. Management is responsible for making all management decisions and performing all management functions, for designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other nonattest services we provide, and for evaluating the adequacy and results of those services and accepting responsibility for them.

Other Engagement Matters and Limitations

As part of our engagement, we will prepare the Federal Form 990 and [*identify other returns*] for the year ended [*date*]. This return will be prepared in accordance with professional standards and may be processed by a contract computer service that has agreed to maintain the confidentiality of all information furnished.

Our work in connection with the preparation of the Form 990 does not include any procedures designed to discover defalcations or other fraud, should any exist.

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You have the final responsibility for the Form 990. Therefore, you should review it carefully before you sign and file it.

Professional standards require us to be independent with respect to the Entity in the performance of our services. Any discussions that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual's base compensation at the Entity, [XX] days from the first day of employment.

Audit Administration, Fees, and Other

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.[5]

Auditing standards generally accepted in the United States of America require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant findings from the audit, including, among others: (*a*) the initial selection of and changes in significant accounting policies and their application; (*b*) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (*c*) significant difficulties that we encountered in dealing with management related to the performance of the audit; (*d*) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (*e*) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (*f*) management representations; (*g*) our views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters; (*h*) major issues that were discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions indicating there could be a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

Assistance to be supplied by your personnel, including the preparation of schedules and analyses of accounts, is described in a separate attachment. Timely completion of this work will facilitate the completion of our audit.

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

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[5] Ethics Ruling No. 112 under Rule 102 (AICPA, *Professional Standards*, ET sec. 191 par. .224-.225) requires that clients be informed if the firm will outsource professional services to third party service providers. If the an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.

Our fees will be billed as work progresses and are based on the amount of time required plus out-of-pocket costs and administrative expenses. Invoices are payable upon presentation. Our initial fee estimate assumes we will receive the aforementioned assistance from your personnel and unexpected circumstances will not be encountered. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees, which we estimate to range from $XX,XXX to $XX,XXX. Additional expenses are expected to be $X,XXX.

The audit documentation for this engagement is the property of Lacko, Lynch, Brown & Company and constitutes confidential information. However, we may be requested to make certain audit documentation available to [*name of regulator*] pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of Lacko, Lynch, Brown & Company personnel. Furthermore, upon request, we may provide photocopies of selected audit documentation to [*name of regulator*]. The [*name of regulator*] may intend, or decide, to distribute the photocopies or information contained therein to others, including governmental agencies.

We appreciate the opportunity to serve you and trust that our association will be a long and pleasant one. If you have any questions, please contact us. If this letter correctly expresses your understanding, please sign the enclosed copy where indicated and return it to us.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

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[*Engagement Partner's Signature*]

Accepted and agreed to:

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[*Client Representative's Signature*]

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[*Title*]

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[*Date*]

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.06 Audit of Not-for-Profit Financial Statements Subject to the Provisions of OMB Circular A-133

LACKO, LYNCH, BROWN & COMPANY — Certified Public Accountants

[*Date*]
Mr. Matt Cox, President
Not-for-Profit Entity
333 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Cox:

This will confirm our understanding of the services we will provide to Not-for-Profit Entity (the Entity) for the year ending December 31, 20XX.[6]

We will audit the statement of financial position of Not-for-Profit Entity as of December 31, 20XX, and the related statements of activities and cash flows for the year then ended, for the purpose of expressing an opinion on them. We also will report on the following additional information accompanying the basic financial statements: (1) schedule of expenditures of federal awards and (2) [*insert additional information here*].

Audit Objectives

The objective of our audit is the expression of an opinion as to whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America and to report on the additional information referenced in the second paragraph of this letter when considered in relation to the financial statements taken as a whole.

Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America; the standards for financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States; the Single Audit Act Amendments of 1996; and the requirements of OMB Circular A-133, and will include tests of accounting records and other procedures we consider necessary to enable us to express such an opinion and to render the required reports. If circumstances preclude us from issuing an unqualified opinion, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or decline to issue a report as a result of the engagement.

We will also provide a report (that does not include an opinion) on internal control related to the financial statements and compliance with the provisions of applicable laws, regulations, contracts, agreements, and grants, noncompliance with which could have a material effect on the financial statements as required by *Government Auditing Standards*. The report on internal control and compliance will include a statement that the report is intended solely for the information and use of management, [*insert audit committee, if applicable*], the board of directors, and specific legislative or regulatory bodies, federal awarding agencies, and if applicable, pass through entities and is not intended to be and should not be used by anyone other than these specified parties. If, during our audit, we become aware that the Company is subject to an audit requirement that is not encompassed in the terms of this engagement, we will communicate to management and those charged with governance that an audit is accordance with auditing standards generally accepted in the United States of America and the standards for financial audits contained in *Government Auditing Standards* may not satisfy the relevant legal, regulatory, or contractual requirements.

Audit Procedures

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Accordingly, the areas and number of transactions selected for testing will involve judgment. An

[6] *Note to users of this sample engagement letter*: You may add to the engagement letter as appropriate, for additional considerations, such as performing procedures relating to a compliance audit of or limited scope audits of subrecipients, the involvement of other auditors (for example, a joint audit with a minority firm), or the auditee's responsibility for obtaining the cooperation of the predecessor auditor.

audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from errors or fraud. Also, an audit is not designed to detect error or fraud that is immaterial to the financial statements. We will inform you of all matters of fraud that come to our attention. We will also inform you of illegal acts that come to our attention, unless they are clearly inconsequential.[7]

Our procedures will include tests of transactions recorded in the accounts, tests of the physical existence of inventory, and direct confirmation of receivables and certain other assets and liabilities by correspondence with selected individuals, funding sources, creditors, legal counsel, and financial institutions. At the conclusion of our audit, we will request certain written representations (a "representation letter") from you about the financial statements and related matters.

Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements or noncompliance may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you and those charged with governance, defined as the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including oversight of the financial reporting process, of any material errors and any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you and those charged with governance of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to matters that might arise during any later periods for which we are not engaged as auditors.

As part of our audit of the basic financial statements, we will obtain an understanding of the Entity and its environment, including its internal control, sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of our auditing procedures for the purpose of expressing our opinion on the financial statements. Our audit is not designed to provide an opinion on the [*abbreviated name*]'s internal control over financial reporting or to identify deficiencies in the design or operation of internal control over financial reporting. However, we are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under Statements on Auditing Standards, *Government Auditing Standards*, and the requirements of OMB Circular A-133.

We also will perform tests of the Entity's compliance with certain provisions of laws, regulations, and the provisions of contracts or grant agreements. However, it is not our objective to provide an opinion on overall compliance with those provisions and, accordingly, we will not express such an opinion.

In planning the audit, we will follow up on known significant findings and recommendations from previous financial audits, attestation engagements, performance audits, or other studies that directly relate to the objectives of the current audit to determine the effect on our risk assessment and audit procedures.

As part of our audit, we will be alert to situations or transactions that could be indicative of abuse, which involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. The determination of abuse is subjective; *Government Auditing Standards* does not expect us to provide reasonable assurance of

[7] Some practitioners prefer to include in an engagement letter a clause that would indemnify them against knowing management misrepresentations in jurisdictions where such clauses are permitted. Ethics Ruling No. 94 under Rule 101 (AICPA, *Professional Standards*, ET sec. 191 par. .188–.189) states that the following indemnification clause in an engagement letter would not impair a CPA's independence: The client agrees to release, indemnify, and holds me (us) (and my (our) partners and our heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Auditors of publicly held companies also should consider the applicable Securities and Exchange Commission rules on independence before including an indemnification clause in an engagement letter. Note that the AICPA PEEC is currently addressing the issue of indemnification clauses.

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detecting abuse, and we will not design the audit to detect abuse. However, if we become aware of indications of material abuse, we will apply procedures to ascertain whether abuse has occurred.

A schedule of expenditures of federal awards will accompany the Entity's basic financial statements. We will subject that schedule to the audit procedures applied in our audit of the basic financial statements and render our opinion on whether that schedule is fairly presented, in all material respects, in relation to the basic financial statements taken as a whole. We also will make specific inquiries of management about that schedule, which management will affirm to us in its representation letter.

Management Responsibilities

The Entity's management is responsible for the basic financial statements and the schedule of expenditures of federal awards as well as all assertions contained therein. Encompassed in that responsibility are the establishment and maintenance of effective internal control over financial reporting; the establishment and maintenance of proper accounting records; the selection of appropriate accounting principles; the safeguarding of assets; and the identification of and compliance with laws, regulations, and the provisions of contracts or grant agreements. Management is responsible for making all financial records and related information available to us and for the accuracy and completeness of that information. Management also is responsible for adjusting the basic financial statements to correct material misstatements and for affirming to us in its representation letter that the effects of any uncorrected misstatements that we accumulate during the current audit and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the basic financial statements.

The Entity's management is responsible for the design and implementation of programs and controls to prevent and detect fraud and for informing us about all known or suspected fraud or illegal acts affecting the Entity involving management, employees who have significant roles in internal control, and others where the fraud or illegal acts could have a material effect on the financial statements. Management's responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud or illegal acts affecting the Entity received in communications from employees, former employees, regulators, or others.

You are responsible for making all management decisions and performing all management functions, for designating an individual with suitable skill knowledge, or experience to oversee the tax services or any other nonattest services we provide, and for evaluating the adequacy and results of those services and accepting responsibility for them.

Compliance Audit of Federal Programs

The Entity's management is responsible for compliance with laws, regulations, and the provisions of contracts or grant agreements related to federal programs. Encompassed in that responsibility is the establishment and maintenance of internal control over compliance that provides reasonable assurance that the Entity is managing federal awards in compliance with laws, regulations, and provisions of contracts or grant agreements.

Our responsibility is to express an opinion on whether the Entity complied with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that could have a direct and material effect on each of the Entity's major federal programs. Following the criteria for federal program risk in OMB Circular A-133, we will determine which federal programs should be considered major programs and thus included within the scope of the compliance audit.[8]

We will plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that are applicable to the Entity's major federal programs could have a direct and material effect on each of its major federal programs. An audit of compliance includes examining, on a test basis, evidence about the Entity's compliance with those requirements and performing such other procedures we consider necessary in the circumstances. Our audit does not provide a legal determination on the Entity's compliance with those requirements.

[8] *Note to users of this sample engagement letter:* This paragraph may be modified if the auditor elects to use a dollar threshold approach to selecting major programs, as allowed by A-133 for first-year single audits.

As part of our audit of compliance applicable to the Entity's major federal programs, we will obtain an understanding of the Entity's internal control over compliance sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of our auditing procedures for the purpose of expressing our opinion on compliance and not to provide assurance on the internal control over compliance. We also will perform testing of internal control as required by OMB Circular A-133. We are responsible for communicating to you and those charged with governance internal control related matters that are required to be communicated under AICPA professional standards, *Government Auditing Standards*, and the requirements of OMB Circular A-133.

We also will follow up on prior audit findings by performing procedures to assess the reasonableness of the Entity's summary schedule of prior audit findings.

We will include in our reports information about the following, if any: material noncompliance with laws, regulations, and provisions of contracts or grant agreements related to major programs; certain known questioned costs; fraud affecting federal awards; abuse that is material to a federal program; and other federal award audit findings as required by *Government Auditing Standards* and OMB Circular A-133.

Other Communications Arising From the Audit

In connection with planning and performing our audit, we will communicate certain matters to appropriate Entity's personnel and to those charged with governance, including our responsibilities for testing and reporting on internal control over financial reporting and on compliance with laws, regulations, and provisions of contracts or grant agreements, both for our financial statement audit and our compliance audit of major federal programs.[9] We also will communicate certain matters of interest, as applicable, to the audit committee, including changes in significant accounting policies or their application, adjustments arising from the audit that could either individually or in the aggregate have a significant effect on the Entity's financial reporting process, and fraud involving senior management that is not otherwise included in our reports.

Auditing standards generally accepted in the United States of America require that we communicate certain additional matters related to the conduct of our audit to those charged with governance. Such matters include (1) our responsibilities under auditing standards generally accepted in the United States of America; (2) an overview of the planned scope and timing of the audit; (3) significant audit findings, including, among others: (*a*) the initial selection of and changes in significant accounting policies and their application; (*b*) the process used by management in formulating particularly sensitive accounting estimates and the basis for our conclusions regarding the reasonableness of those estimates; (*c*) serious difficulties that we encountered in dealing with management related to the performance of the audit; (*d*) audit adjustments that could, in our judgment, either individually or in the aggregate, have a significant effect on your financial reporting process and uncorrected misstatements of the financial statements that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole; (*e*) any disagreements with management, whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the financial statements or our report; (*f*) management representations; (*g*) our views about matters that were the subject of management's consultation with other accountants about auditing and accounting matters; (*h*) major issues that were discussed with management in connection with the retention of our services, including, among other matters, any discussions regarding the application of accounting principles and auditing standards, and if applicable, events or conditions indicating there could be a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time; and (4) other matters as considered necessary or required to be communicated under professional standards.

In planning and performing our audit, we will ask management, those charged with governance, the internal auditor, and others within the entity about fraud or suspected fraud; allegations of fraud or suspected fraud; the risks of fraud; programs and controls established to prevent and detect fraud; whether management has communicated information about those programs and controls to those charged with governance; and how management communicates to employees its views on business practices and ethical behavior.

[9] *Note to users of this sample engagement letter: Government Auditing Standards* paragraphs 4.08–.09 specify the parties to whom this communication should be made.

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We also may communicate in a management letter certain matters identified during the audit or possible ways to improve the Entity's operational efficiency and effectiveness or otherwise improve its internal control or other policies or procedures. Under GAAS and *Government Auditing Standards*, we also may be required to directly report fraud, illegal acts, violations of provisions of contracts or grant agreements, and abuse to outside parties.

Other Engagement Matters and Limitations

As part of our engagement, we will prepare the Federal Form 990 [*and identify other returns*] for the year ended [*date*]. This return will be prepared in accordance with professional standards and may be processed by a contract computer service that has agreed to maintain the confidentiality of all information furnished.

Our work in connection with the preparation of Form 990 does not include any procedures designed to discover defalcations or other fraud, should any exist.

You have the final responsibility for the Form 990. Therefore, you should review it carefully before you sign and file it.

Professional standards require us to be independent with respect to the [*abbreviated name*] in the performance of our services. Any discussion that you have with personnel of our firm regarding employment could pose a threat to our independence. Therefore, we request that you inform us prior to any such discussions so that we can implement appropriate safeguards to maintain our independence. In addition, if you hire one of our personnel, you agree to pay us a fee of [XX] percent of that individual's base compensation at the [*abbreviated name*], [XX] days from the first day of employment.

Audit Administration, Fees, and Other

We may from time to time, and depending on the circumstances, use third party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third party service provider. Furthermore, we will remain responsible for the work provided by any such third party service providers.[10]

The Entity agrees to make available to us all records, documentation, and information we request in connection with our audit, to disclose to us all material information, and to give to us the full cooperation of the Entity's personnel. An enclosure to this letter describes the assistance to be supplied by Entity personnel, including preparation of schedules and analyses of accounts, and the timing for that assistance. Timely completion of that work will facilitate the conclusion of our audit.

The Entity agrees to provide us printer's proofs of its basic financial statements, schedule of expenditures of federal awards, and other information for its Circular A-133 reporting package for our review and approval before printing. The [abbreviated name] also agrees to provide us with a copy of the final reproduced material for our approval before distributing it.

The Entity also is responsible for:

- Taking timely and appropriate steps to remedy fraud, illegal acts, violations of provisions of contracts or grant agreements, or abuse that we report.
- Having a process to track the status of audit findings and recommendations.

---

[10] Ethics Ruling No. 112 under Rule 102 (AICPA, *Professional Standards*, ET sec. 191 par. .224–.225) requires that clients be informed if the firm will outsource professional services to third party service providers. If the an audit firm intends to use third party service providers (that is, entities not controlled by the audit firm or individuals not employed by the audit firm), to perform portions of the audit (for example, input tax return information, act as a specialist, or audit an element of the financial statements), the client must be informed before confidential client information is shared with the service provider. If a third party service provider is not used to perform professional services, this paragraph can be omitted.

- Identifying for us previous financial audits, attestation engagements, performance audits, or other studies related to the objectives of our audit and the corrective actions taken to address significant findings and recommendations.
- Providing its views on our current findings, conclusions, and recommendations, as well as management's planned corrective actions, for our reports. The corrective action plan that the Entity develops for its OMB Circular A-133 reporting package may fully or partially satisfy this responsibility.

Our reports on the Entity's internal control and compliance will state that they are intended solely for the information and use of those charged with governance, management, federal awarding agencies, and pass-through entities and are not intended to be and should not be used by anyone other than these specified parties. However, the Entity should make copies of our reports available for public inspection unless they are restricted by law or regulation, or contain privileged and confidential information.

The documentation for this audit is our firm's property and constitutes confidential information. We will maintain that documentation for the minimum period of time required by applicable auditing standards and requirements. In accordance with *Government Auditing Standards*, OMB Circular A-133, and federal law, we may be required, upon request, to make certain of that documentation (including photocopies) available to other auditors or reviewers, including the cognizant or oversight agency for audit or its designee, a federal agency providing direct or indirect funding, and the U.S. Government Accountability Office. Those parties may intend, or decide, to distribute the photocopies or information contained therein to others, including other governmental agencies and the public. We will notify you of any such requests.

Our firm undergoes a periodic external peer review that examines the quality of our auditing practice. We are enclosing with this letter a copy of the report and letter of comment from our firm's most recent external peer review.

We are always available to meet with you or other executives at various times throughout the year to discuss current business, operational, accounting, and auditing matters affecting the Entity. Whenever you feel such meetings are desirable, please let us know. We also are prepared to provide services to assist you in any of these areas. We also will be pleased, at your request, to attend your directors' meetings.

If the Entity wishes to assert that it complied, in all material respects, with specified laws and regulations, we could perform an engagement in accordance the American Institute of Certified Public Accountants' and *Government Auditing Standards'* attestation standards. The procedures we would perform would be more limited than if we were to express an opinion on management's assertions.

Our fee estimate, which is shown in a separate schedule, is based on a "core" amount for the financial statement audit and tax return preparation services plus an incremental amount for the compliance audit of federal programs, based on the Entity's actual number of major programs.[11] We also will charge the Entity for our out-of-pocket expenses. We will bill our fees as work progresses with payment to be made upon presentation. Our initial fee estimate and our target date for delivering our reports assume that we will receive the aforementioned assistance from Entity personnel and that we will not encounter unexpected circumstances. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of fees or our report delivery date, which is on or about [*date*]. Prior to the release of the audit reports, we will require payment of 100 percent of all fees billed.

[11] *Note to users of this sample engagement letter:* Various factors may change the level of effort required for the compliance audit of federal programs from year-to-year. For example, the auditee may have more or fewer federal programs or major programs because of new or discontinued federal programs, increased or decreased federal funding for existing programs, and OMB changes in program clusters, or the auditee may achieve or lose low risk auditee status. As shown in this sample letter, auditors could consider pricing their services for the compliance audit based on the number of major programs to be audited.

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Our charges for other services will be agreed to separately.

* * *

The arrangements described in this letter will be updated annually.

Sincerely,

LACKO, LYNCH, BROWN & COMPANY

____

[*Engagement Partner's Signature*]

Accepted and agreed to:

____

[*Client Representative's Signature*]

____

[*Title*]

____

[*Date*]

Attachments: Required assistance from [*Name of Client*] personnel; peer review report and letter of comment for the CPA firm's most recent peer review; fee schedule

.07 Audit of Financial Institution Financial Statements

LACKO, LYNCH, BROWN & COMPANY

Certified Public
Accountants

[*Date*]
Mr. Matt Cox, President
Financial Institution
333 Burnside Highway
Sharpsburg, Maryland 00000

Dear Mr. Smith:

We are pleased to confirm our understanding of the services we are to provide for Financial Institution (the "Bank") for the year ended December 31, 20XX.

We will audit the balance sheet of Financial Institution as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended.

The objective of our audit is the expression of an opinion about whether your financial statements are fairly presented, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Our audit will be conducted in accordance with auditing standards generally accepted in the United States of America and will include tests of your accounting records and other procedures we consider necessary to enable us to express such an opinion. If our opinion is other than unqualified, we will discuss the reasons with you in advance. If, for any reason, we are unable to complete the audit or are unable to form or have not formed an opinion, we may decline to express an opinion or to issue a report as a result of this engagement.

Our procedures will include tests of documentary evidence and other procedures supporting the transactions recorded in the accounts. We will also request written representations from your attorneys as part of the engagement, and they may bill you for responding to this inquiry. At the conclusion of our audit, we will require certain written representations from you about the financial statements and related matters.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; therefore, our audit will involve judgment about the number of transactions to be examined and the areas to be tested. We will plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether from (*a*) errors, (*b*) fraudulent financial reporting, (*c*) misappropriation of assets, or (*d*) violations of laws or governmental regulations that are attributable to the entity or to acts by management or employees acting on behalf of the entity. Because an audit is designed to provide reasonable, but not absolute, assurance and because we will not perform a detailed examination of all transactions, there is a risk that material misstatements may exist and not be detected by us. In addition, an audit is not designed to detect immaterial misstatements or violations of laws or governmental regulations that do not have a direct and material effect on the financial statements. However, we will inform you of any material errors that come to our attention, and we will inform you of any fraudulent financial reporting or misappropriation of assets that comes to our attention. We will also inform you of any violations of laws or governmental regulations that come to our attention, unless clearly inconsequential. Our responsibility as auditors is limited to the period covered by our audit and does not extend to any later periods for which we are not engaged as auditors.

Our audit will include obtaining an understanding of internal control sufficient to plan the audit and to determine the nature, timing, and extent of audit procedures to be performed. An audit is not designed to provide assurance on internal control or to identify deficiencies in internal control. However, during the audit, we will communicate to you internal control related matters that are required to be communicated under professional standards.

In accordance with auditing standards promulgated by the AICPA, we will communicate certain matters related to the conduct and results of the audit to those charged with governance. Such matters include, when

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applicable, disagreements with management, whether or not resolved; serious difficulties encountered in performing the audit; our level of responsibility under auditing standards promulgated by the AICPA for the financial statements, for internal control, and for other information in documents containing the audited financial statements; unrecorded audit differences that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements as a whole; changes in the Bank's significant accounting policies and methods for accounting for significant unusual transactions or for controversial or emerging areas; our judgments about the quality of the Bank's accounting principles; our basis for conclusions as to sensitive accounting estimates; management's consultations, if any, with other accountants; and major issues discussed with management prior to our retention.

Management of the Bank is responsible for apprising us of all allegations involving financial improprieties received by management or those charged with governance (regardless of the source or form and including, without limitation, allegations by "whistle-blowers"), and providing us full access to these allegations and any internal investigations of them, on a timely basis. Allegations of financial improprieties include allegations of manipulation of financial results by management or employees, misappropriation of assets by management or employees, intentional circumvention of internal controls, inappropriate influence on related party transactions by related parties, intentionally misleading Lacko, Lynch, Brown & Company ("LLBC"), or other allegations of illegal acts or fraud that could result in a misstatement of the financial statements or otherwise affect the financial reporting of the Bank. If the Bank limits the information otherwise available to us under this paragraph (based on the Bank's claims of attorney/client privilege, work product doctrine, or otherwise), the Bank will immediately inform us of the fact that certain information is being withheld from us. Any such withholding of information could be considered a restriction on the scope of the audit and may prevent us from opining on the Bank's financial statements; alter the form of report we may issue on such financial statements; or otherwise affect our ability to continue as the Bank's independent auditors. The Bank and we will disclose any such withholding of information to those charged with governance.

In accordance with FDIC regulations, we, as your auditors, are required to make the following commitments: The audit documentation for this engagement is the property of LLBC and constitutes confidential information. However, we may be requested to make certain attest documentation available to the FDIC or any other applicable Federal or state banking agency pursuant to authority given to it by law or regulation. If requested, access to such audit documentation will be provided under the supervision of LLBC personnel. Furthermore, upon request, we may provide copies of selected audit documentation to the FDIC or other applicable Federal or state banking agency. The FDIC or other applicable Federal or state banking agency may intend, or decide, to distribute the copies or information contained therein to others, including other governmental agencies.

We may from time to time, and depending on the circumstances, use third-party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third-party service provider. Furthermore, we will remain responsible for the work provided by any such third-party service providers.

You are responsible for establishing and maintaining internal controls, including monitoring ongoing activities; for the selection and application of accounting principles; and for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. You are also responsible for management decisions and functions; for designating an individual with suitable skill, knowledge, or experience to oversee the tax services and any other nonattest services we provide; and for evaluating the adequacy and results of those services and accepting responsibility for them.

You are responsible for making all financial records and related information available to us and for the accuracy and completeness of that information. Your responsibilities include adjusting the financial statements to correct material misstatements and confirming to us in the management representation letter that

the effects of any uncorrected misstatements aggregated by us during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

You are responsible for the design and implementation of programs and controls to prevent and detect fraud, and for informing us about all known or suspected fraud affecting the Bank involving (*a*) management, (*b*) employees who have significant roles in internal control, and (*c*) others where the fraud could have a material effect on the financial statements. Your responsibilities include informing us of your knowledge of any allegations of fraud or suspected fraud affecting the Bank received in communications from employees, former employees, regulators, or others. In addition, you are responsible for identifying and ensuring that the entity complies with applicable laws and regulations.

With regard to the electronic dissemination of audited financial statements, including financial statements published electronically on your Internet website, you understand that electronic sites are a means to distribute information and, therefore, we are not required to read the information contained in these sites or to consider the consistency of other information in the electronic site with the original document.

You should be aware that certain communications involving tax advice between you and members of our firm who are authorized tax practitioners or their agents may be privileged from disclosure to the IRS. The privilege may be waived, however, by voluntarily disclosing the contents of those communications to a third party. The privileged information might be used by you in preparing your financial statements and, consequently, disclosed to us in auditing those statements. In addition, professional standards require us to discuss matters that may affect the audit with our firm personnel responsible for tax services, who may disclose the privileged information to us. The IRS might take the position that such communication results in a waiver of privilege.

In the unlikely event that differences concerning LLBC's services or fees should arise that are not resolved by mutual agreement, to facilitate judicial resolution and save time and expense of both parties, the Bank and LLBC agree not to demand a trial by jury in any action, proceeding or counterclaim arising out of or relating to LLBC's services and fees for this engagement and agree to submit to voluntary mediation.

Attached hereto is a copy of a letter that we will request your principal officers to sign at the commencement of our audit. It sets forth, in summary fashion, our respective responsibilities with respect to your financial statements and our audit thereof.

We understand that your employees will prepare all confirmations we request and will locate any documents selected by us for testing. All confirmations will be prepared as of September 30, 20XX, with the exception of legal council and investment confirmations. We expect to begin our audit during October 20XX. Please note that we are required under accounting regulations to issue our report as close to the audit opinion date as possible. We expect the majority of the documentation necessary to perform our audit to be available at the date of fieldwork commencement mentioned above. Our audit engagement ends on delivery of our audit report. We expect to provide you with a final draft of the Bank's audited financial statements on January 16, 20XX, given that we have been provided by management the first draft by January 4, 20XX. Any follow-up services that might be required will be a separate, new engagement. The terms and conditions of that new engagement will be governed by a new, specific engagement letter for that service. We will also prepare the Bank's tax returns for the year ended December 31, 20XX.

We estimate that our fees for these services will range from $______ to $______ for the audit and $______ for the tax return. You will also be billed for travel and other out-of-pocket costs such as report production, word processing, postage, etc. The fee estimate is based on anticipated cooperation from your personnel and the assumption that unexpected circumstances will not be encountered during the audit. If significant additional time is necessary, we will discuss it with you and arrive at a new fee estimate before we incur the additional costs. Our invoices for these fees will be rendered each month as work progresses and are payable on presentation. In accordance with our firm policies, work may be suspended if your account becomes 30 days or more overdue and will not be resumed until your account is paid in full. If we elect to terminate our services for nonpayment, our engagement will be deemed to have been completed upon written notification of termination, even if we have not completed our report. You will be obligated to compensate us for all time expended and to reimburse us for all out-of-pocket expenditures through the date of termination.

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You may request that we perform additional services not addressed in this engagement letter. If this occurs, we will communicate with you regarding the scope of the additional services and the estimated fees. We also may issue a separate engagement letter covering the additional services. In the absence of any other written communication from us documenting such additional services, our services will continue to be governed by the terms of this engagement letter.

In the event we are requested or authorized by the Bank or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagements for the Bank, the Bank will, so long as we are not a party to the proceeding in which the information is sought, reimburse us for our professional time and expenses, as well as the fees and expenses of our counsel, incurred in responding to such requests.

This engagement letter is contractual in nature, and includes all of the relevant terms that will govern the engagement for which it has been prepared. The terms of this letter supersede any prior oral or written representations or commitments by or between the parties. Any material changes or additions to the terms set forth in this letter will only become effective if evidenced by a written amendment to this letter, signed by all the parties.

We appreciate the opportunity to be of service to you and believe this letter accurately summarizes the significant terms of our engagement. If you have any questions, please let us know. If you agree with the terms of our engagement as described in this letter, please sign the enclosed copy and return it to us.

Very truly yours,

LACKO, LYNCH, BROWN & COMPANY

____

[*Engagement Partner's Signature*]

For the Firm

RESPONSE:

This letter correctly sets forth the understanding of the Bank.

____

[*Signature*]

____

[*Title*]

____

[*Date*]

[*The next page is 4001.*]

AAM Section 4000
Internal Control

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

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

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AAM Section 4100

Introduction

Overview

.01 As discussed in section 3125, "Obtaining an Understanding of Internal Control," the auditor should obtain an understanding of the five components of internal control sufficient to assess the risks of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures. A *sufficient* understanding means the auditor should perform risk assessment procedures to evaluate the design of controls relevant to an audit and to determine whether they have been implemented. In obtaining this understanding, the auditor should consider how an entity's use of IT and manual procedures may affect controls relevant to the audit.

.02 AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), provides a framework to help the auditor obtain an understanding of internal control. This framework breaks internal control into five components as identified in paragraph .03 of section 4200, "Internal Control Framework." The division of internal control into the five components provides a useful framework for auditors to consider how different aspects of an entity's internal control may affect the audit.

.03 The auditor's understanding of internal control is used to

- identify types of potential misstatement;
- consider factors that affect the risks of material misstatement;
- design tests of controls, when applicable; and
- design substantive procedures.

.04 The auditor's understanding of a client's internal control should be based on previous experience with the client and the following:

- Inquiries of appropriate management, supervisory, and staff personnel
- Analytical procedures
- Inspection of documents and records
- Observation of the entity's activities and operations

.05 Section 4200 provides more detail on the internal control framework described in AU section 314. Refer to section 5100, "Designing Further Audit Procedures," for guidance pertaining to the design of further audit procedures (tests of controls or substantive procedures, or both) and section 5200, "Performing Tests of Controls," for specific guidance on the performance of tests of controls.

[*The next page is 4201.*]

AAM Section 4200

Internal Control Framework

Introduction

.01 As described in section 3125, "Obtaining an Understanding of Internal Control," AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), provides a framework to help the auditor obtain an understanding of internal control. That framework is built on 2 concepts: objectives and components.

.02 An *objective* is what the entity is trying to achieve. Generally, an entity tries to achieve objectives in the following three categories:

- Reliability of financial reporting
- Effectiveness and efficiency of operations
- Compliance with applicable laws and regulations

.03 For each of these objectives, internal control consists of the following five interrelated components:

- *Control environment*, which sets the tone of an organization and influences the control consciousness of its people. It is the foundation for all other components of internal control and provides discipline and structure.
- *Risk assessment*, which is the entity's identification and analysis of relevant risks to achievement of its objectives. It forms a basis for determining how the risks should be managed.
- *Control activities*, which are the policies and procedures that help ensure management directives are carried out.
- *Information and communication systems*, which support the identification, capture, and exchange of information in a form and time frame that enables people to carry out their responsibilities.
- *Monitoring*, which is a process that assesses the quality of internal control performance over time.

.04 Although an entity's internal control addresses objectives referred to in paragraph .02, not all of these objectives and related controls are relevant to an effective audit of an entity's financial statements. Ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements that are fairly presented in conformity with generally accepted accounting principles (GAAP), including the management of risks that may give rise to risks of material misstatement in those financial statements. An entity may have controls that relate to operations and compliance with laws and regulations that are not relevant to an audit and, therefore, need not be considered.

.05 *The Jones family owns and operates several neighborhood grocery stores in Anytown. The bank reconciliation performed by the Jones Grocery controller is an example of a control that relates primarily to the* financial reporting *objective. Jones also has an inventory tracking and management system that allows each store manager to track inventory levels and order new items before they run out of stock. This control activity is part of the* operations *objective. Each store has a small deli that prepares sandwiches and some hot foods. These food preparation activities must comply with state health laws and regulations, and Jones has policies in place to help ensure that those laws and regulations are met. Those policies are directed at the* compliance *objective of the entity.*

.06 *The controls having to do with the ordering of inventory or compliance with state health laws and regulations are important to Jones Grocery but ordinarily will not relate to the audit of the company's financial statement. If you*

were the auditor of Jones Grocery, you may wish to ask about and document these controls for client service or other purposes, but because these controls are not relevant to the audit, you are not required to do so.

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

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

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

.09 Controls relating to operations and compliance objectives may, however, be relevant to an audit if they pertain to information or data the auditor may evaluate or use in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

.10 Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each of the components of internal control, the auditor's consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

.11 The internal control framework described in AU section 314 is only a means to help the auditor consider the impact of an entity's internal control in an audit. The auditor's primary consideration is whether, and how, a specific control prevents or detects and corrects material misstatements in relevant assertions related to classes of transactions, account balances, or disclosures, rather than its classification into any particular component. Controls relevant to the audit are those that individually or in combination with others are likely to prevent or detect material misstatements in financial statement assertions. Such controls may exist in any of the five components.

.12 *Suppose you are the auditor of Jones Grocery. As on all audits, you should obtain an understanding of internal control sufficient to assess the risks of material misstatement and to design the nature, timing, and extent of further audit procedures. To achieve this, you organize your inquiries and other procedures to understand each of the five components of internal control that relate to the financial reporting objectives. As a result of performing your procedures, you discover the client's bank reconciliation procedures. Should a bank reconciliation be considered a "control procedure"? What about the fact that someone follows up and investigates old or unusual reconciling items? Is that considered a "monitoring" activity?*

.13 *These questions are rhetorical because the issue of how to classify a particular control is irrelevant for your purposes. As an auditor, your primary consideration is to understand how the bank reconciliations, whether individually or in combination with other controls, affect financial statement assertions relating to cash.*

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Effect of IT on Internal Control

.14 An entity's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, or compliance objectives and its operating units or business functions. For example, an entity may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, an entity may have complex, highly integrated systems that share data and that are used to support all aspects of the entity's financial reporting, operations, and compliance objectives.

.15 The use of IT also affects the fundamental manner in which transactions are initiated, authorized, recorded, processed, and reported. In a manual system, an entity uses manual procedures and records in paper format (for example, individuals may manually record sales orders on paper forms or journals, authorize credit, prepare shipping reports and invoices, and maintain accounts receivable records). Controls in such a system also are manual and may include such procedures as approvals and reviews of activities, reconciliations, and follow-ups of reconciling items. Alternatively, an entity may have information systems that use automated procedures to initiate, authorize, record, process, and report transactions, in which case records in electronic format replace such paper documents as purchase orders, invoices, shipping documents, and related accounting records. Controls in systems that use IT consist of a combination of automated controls (for example, controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT.

.16 IT provides potential benefits of effectiveness and efficiency for an entity's internal control because it enables an entity to

- consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- enhance the timeliness, availability, and accuracy of information;
- facilitate the additional analysis of information;
- enhance the ability to monitor the performance of the entity's activities and its policies and procedures;
- reduce the risk that controls will be circumvented; and
- enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

.17 IT also poses specific risks to an entity's internal control, including

- reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both;
- unauthorized access to data that may result in destruction of data or improper changes to data, including the recording of unauthorized or nonexistent transactions or inaccurate recording of transactions;
- unauthorized changes to data in master files;
- unauthorized changes to systems or programs;
- failure to make necessary changes to systems or programs;
- inappropriate manual intervention; and

- potential loss of data or inability to access data as required.

.18 The extent and nature of these risks to internal control vary depending on the nature and characteristics of the entity's information system. For example, multiple users, either external or internal, may access a common database of information that affects financial reporting. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data. When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This could result in unauthorized transactions or changes to programs or data that affect the financial statements. Therefore, the nature and characteristics of an entity's use of IT in its information system affect the entity's internal control.

.19 Manual controls of systems may be more suitable where judgment and discretion are required, such as for the following circumstances:

- Large, unusual, or nonrecurring transactions
- Circumstances where misstatements are difficult to define, anticipate, or predict
- In changing circumstances that require a control response outside the scope of an existing automated control
- In monitoring the effectiveness of automated controls

.20 Manual controls are performed by people and, therefore, pose specific risks to the entity's internal control. Manual controls may be less reliable than automated controls because they can be more easily bypassed, ignored, or overridden and they are also more prone to errors and mistakes. Consistency of application of a manual control element cannot, therefore, be assumed. Manual systems may be less suitable for the following:

- High volume or recurring transactions, or in situations in which errors that can be anticipated or predicted can be prevented or detected by control parameters that are automated
- Control activities in which the specific ways to perform the control can be adequately designed and automated

.21 The purpose of this section is to provide guidance on each of the five components that comprise the internal control framework. This guidance may help the auditor perform procedures to obtain an understanding of internal control. These procedures generally include the following steps:

- Understand internal control components that have a pervasive effect on the organization
- Understand how IT is used to process significant accounting information
- Understand control activities for significant account balances or transaction cycles
- Assess the risks of management override and lack of segregation of duties

Focus on the Small Business Entity

.22 This section emphasizes the audit of a small business entity. Small business entities are typically characterized by

- a single owner or a small group of owners who manage the business on a day to day basis;
- a small number of employees involved in the accounting function;
- no outside board of directors or internal audit function; and
- the use of off-the-shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

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.23 This section provides some guidance for the audits of medium to large businesses.

Controls Relevant to Reliable Financial Reporting and to the Audit

.24 There is a direct relationship between an entity's objectives and the internal control components it implements to provide reasonable assurance about their achievement. In addition, internal control is relevant to the entire entity or to any of its operating units or business functions. Although the entity's objectives and, therefore, controls relate to financial reporting, operations, and compliance, not all of these objectives and controls are relevant to the audit. Further, although internal control applies to the entire entity, or to any of its operating units or business functions, an understanding of internal control relating to each of the entity's operating units and business functions may not be necessary to the performance of the audit.

.25 Ordinarily, controls that are relevant to an audit pertain to the entity's objective of preparing financial statements that are fairly presented in conformity with GAAP, including the management of risks that may give rise to risks of material misstatement in those financial statements. However, it is not necessary to assess all controls in connection with assessing the risks of material misstatement and designing and performing further audit procedures in response to assessed risks. It is a matter of the auditor's professional judgment as to the controls or combination of controls that should be assessed. However, as stated in paragraph .115 of AU section 314, for significant risks—to the extent the auditor has not already done so—the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented. In exercising that judgment, the auditor should consider the circumstances, the applicable component, and factors such as the following:

- Materiality
- The size of the entity
- The nature of the entity's business, including its organization and ownership characteristics
- The diversity and complexity of the entity's operations
- Applicable legal and regulatory requirements
- The nature and complexity of the systems that are part of the entity's internal control, including the use of service organizations

.26 Controls over the completeness and accuracy of information produced by the entity may also be relevant to the audit if the auditor intends to make use of the information in designing and performing further audit procedures. The auditor's previous experience with the entity and information obtained in understanding the entity and its environment and throughout the audit assist the auditor in identifying controls relevant to the audit.

.27 Controls relating to operations and compliance[1] objectives may, however, be relevant to an audit if they pertain to information or data the auditor may evaluate or use in applying audit procedures. For example, controls pertaining to nonfinancial data that the auditor may use in analytical procedures, such as production statistics, or controls pertaining to detecting noncompliance with laws and regulations that may have a direct and material effect on the financial statements, such as controls over compliance with income tax laws and regulations used to determine the income tax provision, may be relevant to an audit.

.28 An entity generally has controls relating to objectives that are not relevant to an audit and, therefore, need not be considered. For example, an entity may rely on a sophisticated system of automated controls to provide efficient and effective operations (such as a manufacturing plant's computerized production scheduling system), but these controls ordinarily would not be relevant to the audit.

.29 Internal control over safeguarding of assets against unauthorized acquisition, use, or disposition may include controls relating to financial reporting and operations objectives. In obtaining an understanding of each

[1] An auditor may need to consider controls relevant to compliance objectives when performing an audit in accordance with AU section 801, *Compliance Audits* (AICPA, *Professional Standards*).

of the components of internal control, the auditor's consideration of safeguarding controls is generally limited to those relevant to the reliability of financial reporting. For example, use of access controls, such as passwords, that limit access to the data and programs that process cash disbursements may be relevant to a financial statement audit. Conversely, safeguarding controls relating to operations objectives, such as controls to prevent the excessive use of materials in production, generally are not relevant to a financial statement audit.

.30 Controls relevant to the audit may exist in any of the components of internal control and a further discussion of controls relevant to the audit is included in paragraphs .67–.101 of AU section 314. In addition, paragraphs .115 and .117 of AU section 314 discuss certain risks for which the auditor should evaluate the design of the entity's controls over such risks and determine whether they have been implemented.

Internal Control Components

Understanding the Control Environment

.31 The control environment component is the foundation upon which all other components of internal control are based, and it sets the tone of an organization. A small business can have unique advantages in establishing a strong control environment. Employees in many smaller businesses interact more closely with top management and are directly influenced by management actions. Through day-to-day practices and actions, management can effectively reinforce the company's fundamental values and directives. The close working relationship also enables senior management to quickly recognize when employees' actions need modification. In obtaining an understanding of the client's control environment, the auditor should obtain sufficient knowledge to understand the attitudes, awareness, and actions of those charged with governance concerning the entity's internal control and its importance in achieving reliable financial reporting. In understanding the control environment, the auditor should concentrate on the implementation of controls because controls may be established but not acted upon. The following paragraphs describe some factors the auditor should consider when evaluating a client's control environment.

.32 *Integrity and ethical values*. The effectiveness of internal control cannot rise above the integrity and ethical values of the owner-manager. Integrity and ethical values are essential elements of the control environment because they affect the design, administration, and monitoring of other internal control components.

.33 Management may *tell you* a great deal about their integrity and ethical values. They may even commit their *words* to a *written document*. Responses to inquiries and written policies are good, but compliance with ethical standards is best ensured by focusing on management's *actions* and how these actions affect the entity on a day to day basis.

.34 For management's integrity and ethical values to have a positive effect on the entity, the following ordinarily should exist:

- The business owner and management should personally have high ethical and behavioral standards.
- These standards should be communicated to company personnel. In a small business, this communication is often informal.
- The standards should be reinforced.

.35 When observing and evaluating management's *actions* be alert for the following:

- *Segregation of personal from business funds and activities*. Many small business owners mix their personal and business activities, for example, the company may pay the owner's credit card bills even if they contain nonbusiness expenditures. The auditor might consider the owner's attitude and the care with which he or she separates the personal from the business activities. It's not unusual for a business to pay the owner's credit card bills, but the more important question is "does the owner reimburse the

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company?" Owners who treat company assets as if they were personal assets set a bad example for employees who may be encouraged to do the same.

- *Dealing with signs of problems*. Consider how management deals with signs that problems exist, particularly when the cost of identifying and solving the problem could be high. For example, suppose a client became aware of a possible environmental contamination on their premises. How would they react? Would they try to hide it, deny its existence, or act evasively if asked about it, or would they actively seek out their auditor's advice or the advice of their attorney?
- *Removal or reduction of incentives and temptations*. Individuals may engage in dishonest, illegal, or unethical acts simply because the owner-manager gives them strong incentives or temptations to do so. Removing or reducing these incentives and temptations can go a long way toward diminishing undesirable behavior.

  The emphasis on results, particularly in the short term, fosters an environment in which the price of failure becomes very high. *Incentives* for engaging in fraudulent or questionable financial reporting practices include the following:

  — Pressure to meet unrealistic performance targets, particularly for short term results

  — High performance-dependent rewards

  — Upper and lower cutoffs on bonus plans

  Temptations for employees to engage in improper practices include the following:

  — Nonexistent or ineffective controls, such as poor segregation of duties in sensitive areas that offer temptations to steal or conceal questionable financial reporting practices

  — Owner-managers who are unaware of actions taken by employees

  — Penalties for improper behavior that are insignificant or unpublicized and thus lose their value as deterrents

- *Management intervention*. There are certain situations where it is appropriate for management to intervene and overrule prescribed policies or procedures for legitimate purposes. For example, management intervention is usually necessary to deal with nonrecurring and nonstandard transactions or events that otherwise might be handled by the financial reporting information system. The auditor might consider whether management has provided guidance on the situations and frequency with which intervention of established controls is appropriate. It is a best practice for management interventions to be documented and explained.

.36 *Commitment to competence*. Competence reflects the knowledge and skills necessary to accomplish tasks that define an individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

.37 *Mrs. Jones has always kept the books for Jones Grocery. She is self-taught, with no formal training in accounting or bookkeeping. There are no plans to replace Mrs. Jones with someone more "qualified." As the auditor of Jones Grocery you recognized the risk of having an untrained bookkeeper and design your audit approach to address such concerns by*

- *training Mr. and Mrs. Jones to call you whenever they have a transaction out of the ordinary*;
- *strongly encouraging Mrs. Jones to take training classes on her accounting software package (she has)*;
- *explaining to Mrs. Jones the importance of key accounting records such as the accounts payable subledger and inventory reports*; *and*
- *teaching Mrs. Jones important basic control functions such as bank reconciliations*.

.38 *Management's philosophy and operating style*. Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include

- the owner-manager's approach to taking and managing business risks;

- attitudes and actions toward financial reporting and tax matters; and
- attitudes and actions toward information processing and accounting functions and personnel.

.39 Management's philosophy and operating style have a significant influence on the control environment, particularly in a small business where the owner-manager dominates the organization, regardless of the consideration given to the other control environment factors. For example, the auditor may be concerned about the client's unduly aggressive attitude toward financial reporting. Not only might this cause the auditor to assess control risk as high for some or all assertions, but it may heighten concerns about irregularities affecting certain assertions.

.40 However, a dominant owner-manager does not necessarily cause the auditor to assess control risk as high.

.41 *Mr. Jones dominates the management of Jones Grocery. He demonstrates a positive attitude toward the control environment and a moderate to conservative attitude toward accepting business risk such as expansion. He is more concerned about taxes than financial reporting. Mr. Jones uses information generated by the financial reporting information system to monitor the financial results of the company and compare it to prior periods. His review of the accounting reports encourages Mrs. Jones and others who help with the accounting to work with greater care. Mr. Jones also performs many control activities himself, such as the review and supervision of the physical inventory counts. Although Mr. Jones is concerned about his income tax liability, you might not view the possible bias to misstate income as a significant risk because of the otherwise positive control environment*.

.42 *Organizational structure*. A client's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and reviewed.

.43 Significant aspects of establishing an organizational structure include considering key areas of authority and responsibility and appropriate lines of reporting. Small business entities usually have fairly simple organizational structures. A highly structured organization with formal reporting lines and responsibilities may be appropriate for large entities, but for a small business, this type of structure may impede the necessary flow of information.

.44 *Assignment of authority and responsibility*. The assignment of authority and responsibility includes, among other things, the following:

- The establishment of reporting relationships and authorization procedures
- The degree to which individuals and groups are encouraged to use initiative in addressing issues and solving problems
- The establishment of limits of authority
- Policies describing appropriate business practices
- Resources provided for carrying out duties

.45 Alignment of authority and accountability often is designed to encourage individual initiatives, within limits. Delegation of authority means surrendering central control of certain business decisions to lower echelons to the people who are closest to everyday business transactions.

.46 A critical challenge is to delegate only to the extent required to achieve objectives. This requires ensuring that risk acceptance is based on sound practices for identifying and minimizing risk, including sizing risks and weighing potential losses versus gains in arriving at good business decisions.

.47 Another challenge is ensuring that all personnel understand the entity's objectives. It is essential that each individual knows how his or her actions interrelate and contribute to achievement of the objectives.

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.48 *Mr. Jones had to decide how to delegate authority and responsibility when he expanded Jones Grocery from the one original store to its present eight store chain spread out over greater Anytown and the surrounding suburbs. One area that proved problematic was setting prices. Mr. Jones assumed that he would be able to set the prices at all of the stores, just like he did for his original store. He felt this was a good procedure because it allowed him some control over profit margins. Problems arose because the competitive pressures were different in different areas of the city. A competitor in the north suburb ran specials or lowered prices on certain items, and a competitor in the west suburb ran specials on different items. It became too difficult for Mr. Jones to keep up with the constantly changing price battles at eight different stores. He eventually delegated this responsibility to the individual store managers. He set a limit on how much a store manager could discount prices without his prior approval, but other than that, the store managers had the freedom to set prices to respond to the changing competitive environment*.

.49 *The responsibility for accounting information was also affected by Jones Grocery's expansion. Mr. Jones' original thought was that each store would be run as a separate business, with separate financial reporting information systems that would be consolidated together at the main store. Problems soon developed in several areas, most notably accounts payable. The store managers were responsible for entering vendor invoices into the computer system. But it seemed that no matter how much Mr. Jones threatened, cajoled, and begged his store managers to enter the invoices on a timely basis, they just couldn't do it consistently. The procedure had to be changed. Now, the store managers only have the responsibility to check incoming goods for quantity and condition. Vendor invoices are sent directly to Mrs. Jones at the main store, and she is responsible for maintaining the accounts payable for all the stores*.

.50 The control environment is greatly influenced by the extent to which individuals recognize that they will be held accountable. This holds true all the way to the owner-manager, who has the ultimate responsibility for all activities within the organization, including internal control.

.51 *Human resource policies and practices*. Human resource policies and practices affect an entity's ability to employ sufficient competent personnel to accomplish its goals and objectives. Human resource policies and practices include an entity's policies and procedures for hiring, orienting, training, evaluating, counseling, promoting, compensating, and taking remedial action. In many small businesses, the policies may not be formalized but they can nevertheless exist and be communicated. The owner-manager can orally make explicit his or her expectations about the type of person to be hired to fill a particular job and may even be active in the hiring process. Formal documentation is not always necessary for a policy to be in place and operating effectively.

.52 *When Mr. and Mrs. Jones added a second store, the hiring of a store manager was easy—they hired their daughter. Adding a third store proved to be more problematic, because the other Jones children had no interest in the family business. Mr. and Mrs. Jones talked at length about the type of person they would hire as a store manager. They finally decided it was more important to hire someone they could trust, someone they felt comfortable with on a personal level rather than someone with an extensive background in the grocery business. They felt they could teach someone the grocery business but not how to be trustworthy. That hiring policy worked, and they've been following it ever since*.

.53 Standards for hiring the most qualified individuals, with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behavior, demonstrate an entity's commitment to competent and trustworthy people. Hiring practices that include formal in-depth employment interviews and informative and insightful presentations on the company's history, culture, and operating style send a message that the company is committed to its people.

.54 Personnel policies that communicate prospective roles and responsibilities and that provide training opportunities indicate expected levels of performance and behavior. Rotation of personnel and promotions driven by periodic performance appraisals demonstrate the entity's commitment to advancement of qualified personnel to higher levels of responsibility. Competitive compensation programs that include bonus incentives serve to motivate and reinforce outstanding performance. Disciplinary actions send a message that violations of expected behavior will not be tolerated.

.55 *Participation of those charged with governance*. An entity's control consciousness is significantly influenced by those charged with governance. As defined in paragraph .03 of AU section 380, *The Auditor's Communication*

With Those Charged With Governance (AICPA, *Professional Standards*), *those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. In some cases, those charged with governance are responsible for approving the entity's financial statements (in other cases management has this responsibility). For entities with a board of directors, this term encompasses the terms *board of directors* or *audit committee*. For small business entities, those charged with governance may not include any independent or outside members. Please refer to paragraphs .81–.83 for additional discussion of how the participation of those charged with governance applies to medium and large businesses.

Risk Assessment

.56 Risk assessment, as it relates to the objective of reliable financial reporting, involves identification and analysis of the risks of material misstatement. Establishment of financial reporting objectives articulated by a set of financial statement assertions for significant accounts is a precondition to the risk assessment process. Risk assessment in small businesses can be relatively efficient, often because in-depth knowledge of the company's operations enables the owner and management to have firsthand information of where risks exist. In carrying out their normal responsibilities, including obtaining information gained from employees, customers, suppliers, and others, these managers identify risks inherent in business processes. In addition to focusing on operations and compliance risks, they are positioned to consider the following risks to reliable financial reporting:

- Failing to capture and record all transactions
- Recording assets that do not exist or transactions that did not occur
- Recording transactions in the wrong period or wrong amount or misclassifying transactions
- Losing or altering transactions once recorded
- Failing to gather pertinent information to make reliable estimates
- Recording inappropriate journal entries
- Improperly accounting for transactions or estimates
- Inappropriately applying formulas or calculations

.57 Risks relevant to financial reporting include events and circumstances that may adversely affect the company's ability to initiate, authorize, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should generally be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations.

.58 Risks can arise or change due to circumstances such as the following:

- *Changes in the operating environment*. Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- *New personnel*. New personnel may have a different focus on or understanding of internal control. When people change jobs or leave the company, management generally should consider the control activities they performed and who will perform them going forward. Steps ordinarily should be taken to ensure new personnel understand their tasks.
- *New or revamped information systems*. Significant and rapid changes in information systems can change the risk relating to internal control. When these systems are changed, management generally should assess how the changes will impact control activities. Are the existing activities appropriate or even possible with the new systems? Personnel should be adequately trained when information systems are changed or replaced.

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- *Rapid growth*. Significant and rapid expansion of operations can strain internal control and increase the risk of a breakdown in internal control. Management generally should consider whether accounting and information systems are adequate to handle increases in volume.
- *New technology*. Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- *New business models, products, or activities*. Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- *Corporate restructurings*. Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- *Expanded foreign operations*. The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control (for example, additional or changed risks from foreign currency transactions).
- *New accounting pronouncements*. Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

.59 The auditor's procedures to assess whether a risk assessment process is placed in operation are generally of an inquiry nature. For example, you may ask accounting personnel what accounts they believe are the most difficult to become satisfied with as they prepare the financial statements. You may also consider asking the same questions of personnel outside the accounting department.

Control Activities

.60 Control activities are the policies and procedures that help ensure management directives are carried out. They help ensure that necessary actions are taken to address risks to achievement of the entity's objectives. Control activities occur throughout the organization at all levels and in all functions. They include a range of activities as diverse as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets, and segregation of duties. When resource constraints compromise the ability to segregate duties, many smaller companies use certain compensating controls to achieve the objectives.

.61 At the entity-wide level, control activities may be categorized as policies and procedures that pertain to the following:

- *Performance reviews*. These control activities include reviews of actual performance versus budgets, forecasts, and prior period performance. They may also involve relating different sets of data (for example, operating or financial) to one another, together with analyses of the relationships, investigating unusual relationships and taking corrective action. Performance reviews may also include a review of functional or activity performance.
- *Information processing*. A variety of controls are performed to check accuracy, completeness, and authorization of transactions. The two broad groupings of information systems control activities are application controls and general controls. Application controls apply to the processing of individual applications. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports. General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls commonly include controls over data center and network operations; system software acquisition, change, and maintenance; access security; and application system acquisition, development, and maintenance. These controls apply to mainframe, miniframe, and end user environments. Examples of such general controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to

or monitor the use of system utilities that could change financial data or records without leaving an audit trail. These controls are discussed in more detail in paragraphs .88–.92.

- *Physical controls*. These activities encompass the physical security of assets, including adequate safeguards over access to assets and records such as secured facilities and authorization for access to computer programs and data files and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation and, therefore, the audit depends on circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.
- *Segregation of duties*. Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and conceal errors or fraud in the normal course of his or her duties. Segregation of duties is often a problem for small business entities. See paragraphs .129–.137 for further discussion and guidance.

.62 You should consider the knowledge about the presence or absence of control activities obtained from the understanding of the other components of internal control in determining whether it is necessary to devote additional attention to obtaining an understanding of control activities. An audit does not require an understanding of all the control activities related to each class of transactions, account balance, and disclosure in the financial statements or to every relevant assertion. Ordinarily, control activities that may be relevant to an audit include those relating to authorization, segregation of duties, safeguarding of assets, and asset accountability, including, for example, reconciliations of the general ledger to the detailed records. The auditor should obtain an understanding of the process of reconciling detail to the general ledger for significant accounts.

.63 In obtaining an understanding of control activities, the auditor's primary consideration is whether, and how, a specific control activity, individually or in combination with others, prevents or detects and corrects material misstatements in classes of transactions, account balances, or disclosures. Control activities relevant to the audit are those for which the auditor considers it necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. The auditor's emphasis is on identifying and obtaining an understanding of control activities that address the areas where you consider that material misstatements are more likely to occur. When multiple control activities achieve the same objective, it is unnecessary to obtain an understanding of each of the control activities related to that objective.

.64 The auditor should obtain an understanding of how IT affects control activities that are relevant to planning the audit. Some entities and auditors may view the IT control activities in terms of application controls and general controls. Application controls apply to the processing of individual applications. Accordingly, application controls relate to the use of IT to initiate, authorize, record, process, and report transactions or other financial data. These controls help ensure that transactions have occurred, are authorized, and are completely and accurately recorded and processed. Examples include edit checks of input data, numerical sequence checks, and manual follow-up of exception reports.

.65 Application controls may be performed by IT (for example, automated reconciliation of subsystems) or by individuals. When application controls are performed by people interacting with IT, they may be referred to as user controls. The effectiveness of user controls, such as reviews of computer produced exception reports or other information produced by IT, may depend on the accuracy of the information produced. For example, a user may review an exception report to identify credit sales over a customer's authorized credit limit without performing procedures to verify its accuracy. In such cases, the effectiveness of the user control (that is, the review of the exception report) depends on both the effectiveness of the user review and the accuracy of the information in the report produced by IT.

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.66 General controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls commonly include controls over data center and network operations; system software acquisition, change, and maintenance; access security; and application system acquisition, development, and maintenance. Though ineffective general controls do not, by themselves, cause misstatements, they may permit application controls to operate improperly and allow misstatements to occur and not be detected. For example, if there are weaknesses in the general controls over access security, and applications are relying on these general controls to prevent unauthorized transactions from being processed, such a general control weakness may have a more severe effect on the effective design and operation of the application control. General controls should be assessed in relation to their effect on applications and data that become part of the financial statements. For example, if no new systems are implemented during the period of the financial statements, weaknesses in the general controls over systems development may not be relevant to the financial statements being audited.

.67 The use of IT affects the way that control activities are implemented. For example, when IT is used in an information system, segregation of duties often is achieved by implementing security controls.

.68 The auditor should consider whether the entity has responded adequately to the risks arising from IT by establishing effective controls, including effective general controls upon which application controls depend. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process.

Information and Communication Systems

.69 Information systems identify, capture, process, and distribute information supporting the achievement of financial reporting objectives. Information systems in small businesses are likely to be less formal than in large ones, but their role is just as significant. Many small businesses rely more on manual or standalone IT applications than complex integrated applications. Effective internal communication between top management and employees may be facilitated in smaller companies due to fewer levels and numbers of personnel and greater visibility and availability of the owner. Internal communication can take place through frequent meetings and day-to-day activities in which the owner and other managers participate.

.70 An information system consists of infrastructure (physical and hardware components), software, people, procedures (manual and automated), and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems make extensive use of IT. The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Authorization includes the process of approving transactions by the appropriate level management. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarization, and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in measuring and reviewing the entity's financial performance and in other functions.

.71 The quality of system generated information affects management's ability to make appropriate decisions in controlling the entity's activities and to prepare reliable financial statements. Thus, it is important that management receives the information they need to carry out their responsibilities and that the information is provided at the right level of detail. Accordingly, an information system encompasses procedures and records that

- identify and record all valid transactions;
- describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting;

- measure the value of transactions in a manner that permits recording of their proper monetary value in the financial statements;
- determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period; and
- present properly the transactions and related disclosures in the financial statements.

.72 The financial reporting information system is an integral part of an entity's information and communication system. The auditor's consideration of the system is often made at the individual account and classes of transaction level. See paragraphs .113–.128 for additional guidance.

.73 The communication component of an entity's internal control involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on. Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

.74 The auditor should obtain sufficient knowledge of the information system, including the related business processes relevant to financial reporting, to understand

- the classes of transactions in the entity's operations that are significant to the financial statements;
- the procedures, both automated and manual, by which transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements;
- the related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, authorizing, recording, processing, and reporting transactions;
- how the information system captures other events and conditions that are significant to the financial statements; and
- the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.75 When IT is used to initiate, authorize, record, process, or report transactions or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for significant accounts or may be critical to the effective functioning of manual controls that depend on IT.

.76 The auditor also should obtain an understanding of how the incorrect processing of transactions is resolved. For example, such understanding might include whether there is an automated suspense file, how it is used by the entity to ensure that suspense items are cleared out on a timely basis, and how system overrides or bypasses to controls are processed and accounted for.

.77 In obtaining an understanding of the financial reporting process (including the closing process), the auditor should understand the automated and manual procedures an entity uses to prepare financial statements and related disclosures, and how misstatements may occur. Such procedures include the following:

- *Entering transaction totals into the general ledger (or equivalent record).* In some information systems, IT may be used to automatically transfer such information from transaction processing systems to general ledger or financial reporting systems. The automated processes and controls in such systems may reduce the risk of inadvertent error but do not overcome the risk that individuals may inappropriately override such automated processes, for example, by changing the amounts being automatically passed to the general ledger or financial reporting system. Furthermore, in planning

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the audit, the auditor should be aware that when IT is used to automatically transfer information there may be little or no visible evidence of such intervention in the information systems.

- *Initiating, authorizing, recording, and processing journal entries in the general ledger.* An entity's financial reporting process used to prepare the financial statements typically includes the use of standard journal entries that are required on a recurring basis to record transactions such as sales, purchases, and cash disbursements or to record accounting estimates that are periodically made by management such as changes in the estimate of uncollectible accounts receivable. An entity's financial reporting process also includes the use of nonstandard journal entries to record nonrecurring or unusual transactions or adjustments such as a business combination or disposal, or a nonrecurring estimate such as an asset impairment. In manual, paper-based general ledger systems, such journal entries may be identified through inspection of ledgers, journals, and supporting documentation. However, when IT is used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may be more difficult to identify through the use of computer assisted techniques.
- *Initiating and recording recurring and nonrecurring adjustments to the financial statements.* These are procedures relating to adjustments and reclassifications that are not reflected in formal journal entries.
- *Combining and consolidating general ledger data*. This includes procedures to combine detailed general ledger accounts, prepare the trial balance, and prepare consolidated financial data (for example, transferring general ledger data and adjusting journals into a consolidation system or spreadsheet; performing consolidation routines; and reconciling and reviewing consolidated financial data, including footnote data).
- *Preparing financial statements and disclosures*. These are procedures designed to ensure that information required to be presented and disclosed is accumulated, recorded, processed, summarized, and appropriately reported in the financial statements.

Monitoring

.78 Internal control systems need to be monitored, which is a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two. Managers of many smaller businesses have high-level firsthand knowledge of company activities, and their close involvement in operations positions them to identify variances from expectations and potential inaccuracies in reported financial information.

.79 Examples of ongoing monitoring activities include the following:

- Management reviews of data produced by the entity's information system. Managers are in touch with operations and may question reports that differ significantly from their knowledge of operations. However, management generally should have a basis for believing the data is accurate. If errors exist in the information, management may make incorrect conclusions from its monitoring activities.
- Communications from external parties corroborate internally generated information or indicate problems. Customers implicitly corroborate billing data by paying their invoices. Conversely, customer complaints about billings could indicate system deficiencies in the processing of sales transactions. Similarly, bankers, regulators, or other outside parties may communicate with the company on matters of accounting significance.
- External auditors regularly provide recommendations on the way internal control can be strengthened. Auditors may identify potential weaknesses and make recommendations to management for corrective action.
- Employees may be required to sign off to evidence the performance of critical control functions. The sign-off allows management to monitor the performance of these control functions.

Application to Medium and Large Businesses

.80 The control environments of medium to large businesses may differ from those of small business entities in the following ways:

- The presence of a board of directors or audit committee
- The presence of an internal audit function
- More formalized policies and procedures

Board of Directors or Audit Committee

.81 The control consciousness of a medium or large business is influenced significantly by those charged with governance. As defined previously, those charged with governance means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. Those charged with governance encompasses the term *board of directors* and *audit committee* used elsewhere in this section. Because of its importance, an active and involved board of directors—possessing an appropriate degree of management, technical, and other expertise coupled with the necessary stature and mind-set so that it can adequately perform the necessary governance, guidance, and oversight responsibilities—is critical to effective internal control.

.82 Factors that influence the effectiveness of those charged with governance include the following:

- Its independence from management
- The experience and stature of its members
- The extent of its involvement and scrutiny of activities
- The appropriateness of its actions
- The degree to which difficult questions are raised and pursued with management
- Its interaction with internal and external auditors

.83 The board of directors must be prepared to question and scrutinize management's activities, present alternative views and have the courage to act in the face of obvious wrongdoing. Because of this, it is necessary that the board contain at least a critical mass of outside directors. The number should suit the entity's circumstances, but more than one outside director normally would be needed for a board to have the requisite balance.

Internal Audit Function

.84 The internal audit function is established within an entity to monitor and evaluate the adequacy and effectiveness of internal control. For entities with an internal audit function, the auditor ordinarily should make inquiries of appropriate management and internal audit personnel about the internal auditors'

- organizational status within the entity;
- application of professional standards;
- audit plan, including the nature, timing, and extent of audit work; and
- access to records and any limitations on the scope of their activities.

.85 After obtaining an understanding of the internal audit function, the auditor may either

- conclude that the internal auditors' activities are not relevant to the financial statement audit and give no further consideration to the internal audit function;
- identify relevant internal auditor activities but conclude that it would not be efficient to consider further the work of the internal auditors; or

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- decide that it would be efficient to consider how the internal auditors' work might affect the nature, timing, and extent of the audit. In this case, you should assess the competence and objectivity of the internal audit function as outlined in AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*).

.86 You may also request direct assistance from the internal auditors. Paragraph .27 of AU section 322 establishes requirements and provides guidance for auditors when using internal auditors to provide direct assistance in performing the audit.

Formal Policies

.87 Medium and large businesses may communicate their policies in formal, written documents. For example, they may have a written code of conduct or human resource policies. The existence of formal policy documents is good, but as an auditor, your primary consideration is how the policies are implemented.

Computer Applications

.88 Small business entities are typically characterized by the use of off the shelf, unmodified computer software or the use of an outside computer service organization to process significant accounting information.

.89 *Jones Grocery has a stand-alone, state-of-the-art PC at its main store. One other store has a computer—an Apple Macintosh that Mr. and Mrs. Jones' daughter used at college. The PC at the main store is used to run the accounting software, which is an off the shelf product developed specifically for independent grocers. The payroll is processed by an outside payroll service.*

.90 In gaining an understanding of how computers are used in the business, the auditor may consider the following:

- The acquisition of hardware and software
- Physical access
- Logical access
- User controls over outsider service bureau applications

Acquisition of Hardware and Software

.91 Companies ordinarily should take steps to ensure they have compatible hardware and software. The use of compatible software reduces the risk of error, because there will be no need to transfer data from one format into another. Even small businesses generally should have a coherent plan for the purchase of computer hardware and software. If the business is growing, management will typically plan for the upgrade of the processor, random access memory (RAM), or hard disk storage.

.92 *Mr. and Mrs. Jones did not plan for the purchase of their computers. For several years, Mrs. Jones processed the accounting applications on an old PC with limited RAM and hard-disk storage. When the Jones' daughter opened the second store, she brought with her the Apple Macintosh she had in college. At first, she tried to transfer data from her store to the main store, but the software had problems converting from the Apple format, so the procedure was abandoned. At a trade show, Mr. Jones discovered a computer software program specifically designed for independent grocers. He was impressed with the program and decided that it fit his needs perfectly. However, his hardware was out of date, and so in order to run the software, he upgraded his hardware. The new software supposedly is able to handle Apple-formatted data, and the company has plans to transfer data from the second store electronically. There are no plans to install computers at the other stores.*

.93 *As the auditor of Jones Grocery, you should use this understanding of the company computer system to help plan the audit. For example, they plan to transfer data from the Apple to the PC. What other sorts of errors might occur in the transfer? What steps has the client taken to prevent or detect those errors? You also know that stores three through*

eight are on a manual system. What types of errors might occur in a manual system? What is the risk that those errors will occur?

.94 Entities ordinarily should also establish policies and procedures to mitigate the risk of computer viruses being introduced into their systems. Viruses can cause the loss of data and programs. A virus has the ability to attach itself to a program and infect other programs and systems. Although some viruses merely write messages across the screen, others can cause serious damage to disk files or shut down a network by replicating themselves millions of times and filling all available memory or disk storage.

.95 Methods to prevent the introduction of viruses and to recover from a virus attack include the following:

- Obtaining recognized software from reputable sources and only accepting delivery of the software in the manufacturer's sealed package.
- Making multiple generations of backups. A virus that is not detected initially may be copied onto more recent backup copies, and the older versions may not be infected.
- Prohibiting the use of unauthorized programs introduced by employees.
- Prohibiting the downloading of untested software from sources such as dial-up bulletin boards.
- Using virus protection software to screen for virus infections.

Physical Security

.96 Physical security—primarily backup and contingency planning—often is ignored by small businesses in a microcomputer environment. Poor backup procedures can result in the loss of important data that are very difficult, time consuming, and costly to recreate, if they can be recreated at all.

.97 Clients generally should have established procedures for the periodic backup of data files and applications. Critical applications and files ordinarily should be stored off-site with corresponding documentation in the event that on-site files become unavailable.

Logical Access

.98 Logical access to computer applications and data files may not be formally or rigorously controlled in a small business. This leaves the company exposed to the risk that files could be inappropriately manipulated or unauthorized transactions entered into the system. For example, without logical access controls a user may be able to enter any or all sections of a general ledger or other financial module and perform file maintenance such as changing the address of an accounts receivable customer or data used to calculate payroll.

.99 Management ordinarily should identify confidential and sensitive data for which access should be restricted. Mechanisms such as password control or the use of menus can be used to limit the access to that data.

.100 In a microcomputer environment, password control may be installed over the operating system using a shell program to prevent the user from accessing menu options of a program. Even if such a restriction exists, a sophisticated user can often bypass the shell by using a utility. Therefore, the use of utility programs generally should be controlled or monitored carefully.

User Controls Over Computer Service Organization Applications

.101 Entities may use an outside computer service organization to process significant accounting information. AU section 324, *Service Organizations* (AICPA, *Professional Standards*), establishes requirements and provides guidance for auditors auditing entities that use computer service organizations.

.102 When using an outside computer service organization, most small businesses typically retain the responsibility for authorizing transactions and maintaining the related accountability. The computer service

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organization merely records user transactions and processes the related data. In these circumstances, the user (the small business) typically maintains controls over the input and output to prevent or detect material misstatement. When the service organization initiates, executes, and does the accounting processing of the user organization's transactions, it may not be practicable for the user organization to implement effective controls for those transactions.

.103 *Jones Grocery uses an outside computer service to process payroll. Time cards are gathered for each store and reviewed by the store manager before being sent to the main store. Mrs. Jones reviews the time cards for the store managers and checks to make sure all personnel have submitted time cards for the pay period. All other payroll transactions such as pay rates, withholdings, and benefits, among others, are sent directly to Mrs. Jones. She forwards all information to the payroll service, which prepares the checks and produces a payroll register. Mrs. Jones reviews the register and checks for any obvious misstatements before she distributes the checks*.

Application to Medium or Large Businesses

.104 Medium and large businesses typically have more complicated computer processing systems than small businesses. They also tend to use the computer for a greater amount of processing. For example, a small business may prepare customer invoices manually by looking up prices on a master price list. A medium size business may maintain master price information on a computer file and use the computer to generate packing slips, sales invoices, and reports of unmatched documents.

.105 Medium and large businesses are also typically characterized by a separate management information services department with formally defined job descriptions and responsibilities.

.106 Instead of using off the shelf, unmodified software, the medium or large business will modify standard software or develop its own applications. Its software may be more complicated than that used by the small business; for example, the medium or large business may use a database management system or telecommunications software.

.107 Medium and large businesses often use a mainframe computer in conjunction with microcomputers or a local area microcomputer network. Information is frequently transferred between the mainframe and microcomputers that may be located on-site or at a remote location.

.108 Control activities in a computerized environment generally comprise a combination of the following:

- User control activities
- Programmed control activities and manual follow-up
- Computer general control activities

.109 *User controls*. User control activities are manual checks of the completeness and accuracy of computer output against source documents or other input. For example, an entity may have programmed procedures in a billing system that calculate sales invoice amounts from shipping data and master price files. The entity may also have a procedure to manually check the completeness and accuracy of the invoices. In many systems, user controls relate only to the completeness of records and not to the accuracy of processing.

.110 *Programmed control activities and manual follow-up activities*. Programmed control activities are those that are built into the computer processing program; for example, the generation of an exception report. However, an exception report is useless unless the client follows up on the items listed. Thus, in addition to understanding the nature of the programmed control activities, the auditor may also obtain an understanding of the related manual follow-up procedures.

.111 *Computer general control activities*. If computer general control activities operate effectively, there is greater assurance that programmed control activities are properly designed and function consistently

throughout the period. The auditor may plan to understand computer general control activities to provide evidence that

- programs are properly designed and tested in development;
- changes to programs are properly made;
- computer operations ensure the proper use of application programs and data files; and
- adequate access controls reduce the risk of unauthorized changes to the program and data files.

.112 The following table summarizes computer general control activities.

Area	*Control Objectives*	*Example Controls*
Program development	• Controls ensure that new applications systems are suitably authorized, designed, and tested	• Users are involved in the design and approval of systems • Checkpoints where users review the completion of various phases of the application • Development of test data and testing of the program • User involvement in the review of tests of the program • Adequate procedures to transfer programs from development to production libraries
Program changes	• Controls over changes to existing programs and systems ensure that modifications to application programs are suitably approved, designed, tested, and implemented	• Same as program development • User involvement • Adequate testing • Adequate transfer activities • Segregation of duties between programmers and production libraries
Computer operations	• Controls ensure that application programs are used properly and that proper data files are used during processing	• Review of lists of regular and unscheduled batch jobs by operations management • Use of menu-driven job control instruction sets • Jobs executed only from the operator's terminal • Adequate procedures for managing and backing up data and program files
Access	• Controls should prevent or detect unauthorized changes to programs and to data files supporting the financial statements	• Programmers have limited access to production programs, live data files, and job control language • Operators have limited access to source code and individual elements of data files • Users have access only to defined programs and data files

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Obtaining an Understanding of Significant Account Balances and Transaction Cycles

.113 As discussed in paragraph .83 of AU section 314, the auditor should obtain sufficient knowledge of the information system, including the related business processes relevant to financial reporting to understand

- the classes of transactions in the entity's operations that are significant to the financial statements;
- the procedures, both automated and manual, by which transactions are initiated, authorized, recorded, processed, and reported from their occurrence to their inclusion in the financial statements;
- the related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, recording, processing, and reporting transactions;
- how the information system captures other events and conditions that are significant to the financial statements; and
- the financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

.114 *Accounting processing*. In obtaining an understanding of how a client processes accounting information—from the initiation of the transaction to its inclusion in the financial statements—the auditor may focus on how the computer is used to process data and the ways in which transactions are valued, classified, and summarized in data files, journals, or ledgers. For some transactions, there may be several significant processing activities and accounting records, including the use of computer programs. Other transactions may involve only limited processing activities performed manually.

.115 *At Jones Grocery, sales are initiated by customers and recorded in the cash register. At the end of the day the cash register totals are reconciled to the cash on hand, and a deposit is prepared for the day's receipts. On a weekly basis, the daily cash register tapes are batched for each store, forwarded to Mrs. Jones, and entered into the computer. The computer generates a sales register, a sales analysis report, and posts the sales totals to the general ledger. Also, the processing of inventory transactions (for example, receipt of goods, sales, and spoilage) involves several processing activities that are linked in the inventory module of the software package. On the other hand, recording depreciation expense is fairly simple. Fixed assets and the related depreciation are maintained on a computer spreadsheet, and each month, Mrs. Jones prepares a journal entry to record depreciation*.

.116 Understanding the accounting processing also involves understanding the information used for processing and when processing occurs. For example, when considering the completeness assertion, the auditor may obtain an understanding about whether transactions entered into the computer system are processed immediately or in batches and how frequently batches are processed.

.117 The processing of accounting information may involve *end user computing*. End user computing occurs when the user is responsible for the development and execution of the computer application that generates the information used by that same person.

.118 *Mrs. Jones developed and maintains the fixed asset spreadsheet that serves as the source document for her monthly depreciation expense journal entry*.

.119 In general, the product of end user computing may be used to

- process significant accounting information outside of the off the shelf accounting software package (for example, the fixed-asset spreadsheet is separate from the Jones Grocery general ledger software package);
- make significant accounting decisions (for example, a spreadsheet application may be used to generate information used to write down inventory); and

- accumulate footnote information (for example, a spreadsheet may be used to calculate the five-year debt maturity disclosure).

.120 Generally, end users have no training in the formal computer application development process. Accordingly, applications developed by end users are often inadequately tested, and the development process is often not documented. This situation can cause significant difficulties for an organization if the end user computing application is critical to making business or financial decisions.

.121 The access to end user computing applications may also be an audit concern. Many computer applications used in end user computing come with on-line systems that are capable of restricting users to specific applications, specific departments, or even specific fields. Often, however, these access restrictions facilities are not implemented.

.122 To address these concerns and to ensure the end user applications process data completely and accurately, the auditor may look for control policies and procedures that

- require all significant end user applications to be adequately tested before use;
- prescribe documentation standards for significant end user applications;
- provide for adequate access controls to data;
- provide a mechanism to prevent or detect the use of incorrect versions of data files;
- provide for appropriate applications controls, for example, edit checks, range tests, or reasonableness checks; and
- support meaningful user reconciliations.

.123 *Accounting records, supporting information, and specific accounts*. In general, the auditor may identify the following for a client's significant accounts and transactions:

- Source documents
- Documents converted to computer media
- Computer files that are further processed in the flow of information to the general ledger and the financial statements
- Accounts (subsidiary or general ledger master files) affected by the transaction
- Relevant accounting reports, journals, and ledgers produced in the flow of information to the general ledger and the financial statements

.124 A client's accounting systems may create many documents, files, and reports that are useful for managing the organization; however, not all will be relevant to the financial statements.

.125 *At Jones Grocery, the sales analysis report described in paragraph .115* is used for management information and analysis. The documents and reports relevant to the financial statements are the daily cash register tapes and the computer generated sales register.

.126 *Other significant events and conditions*. The entity's information system may capture other events and conditions that are significant to the financial statements. This might involve, for example, nonrecurring or unusual transactions or adjustments and nonrecurring estimates.

.127 *A broken water line, which is an uninsured risk, spoiled a large amount of produce and dry goods in one of the Jones Grocery stores. Based on a list of the lost inventory provided by the store manager, Mrs. Jones recorded a large spoilage loss.*

.128 *Financial reporting process*. When gaining an understanding of the financial reporting process, the auditor may determine the extent of client procedures to prepare accounting estimates (when significant

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accounting estimates are called for) and information for significant disclosures. The auditor may also understand the way in which general ledger information is summarized to determine how the amounts and disclosures are reported in the financial statements.

Segregation of Duties and Management Override

.129 Small businesses are typically characterized by the following:

- A dominant owner-manager
- A lack of segregation of duties

.130 These characteristics may pose unique risks to the entity.

.131 Duties generally should be divided among different people to reduce the risks of error or inappropriate actions. For instance, responsibilities for authorizing transactions, recording them, and handling the related assets could be divided.

.132 Even small businesses with only a few employees can usually parcel out responsibilities to achieve the necessary checks and balances. If that is not possible—which may be the case on occasion—direct oversight of the incompatible activities by the owner-manager can provide the necessary control. Thus, a dominant owner-manager may be a positive element in the design of internal control.

.133 A dominant owner-manager may be a negative element in the design of internal control when he or she is able to override established policies and procedures.

.134 Management *override* is different from management *intervention*. *Management intervention* is discussed in paragraph .35 and is described as the overrule of internal control for legitimate purposes. For example, management intervention is usually necessary to deal with nonrecurring and nonstandard transactions or events that otherwise might be handled by the system.

.135 In contrast, *management override* is the overrule of internal control for illegitimate purposes with the intent of personal gain or enhanced presentation of an entity's financial condition or compliance status.

.136 An owner-manager might override internal control for many reasons:

- To increase or decrease reported revenue
- To boost market value of the entity prior to sale
- To meet sales or earnings projections
- To bolster bonus pay-outs tied to performance
- To appear to cover violations of debt covenant agreements
- To hide lack of compliance with legal requirements

Override practices include deliberate misrepresentations to bankers, lawyers, accountants, and vendors, as well as intentionally issuing false documents such as sales invoices.

.137 When gaining an understanding of internal control, the auditor assesses the risk of management override.

Assessing Internal Control Strengths and Weaknesses

.138 When obtaining an understanding of internal control, the auditor may consider the *collective* effect of strengths and weaknesses in various control environment factors. Management's strengths and weaknesses may have a pervasive effect on internal control. For example, owner-manager controls may mitigate a lack

of segregation of duties. However, human resource policies and practices directed toward hiring competent financial and accounting personnel may not mitigate a strong bias by top management to overstate earnings.

.139 Internal control strengths may indicate account balances, transaction classes, or assertions where you can assess control risk at low or moderate.[2] Internal control weaknesses usually indicate areas where substantive procedures may be required. However, in situations where electronic evidence (information transmitted, processed, maintained, or accessed by electronic means) is significant, testing of the related internal control generally is necessary to obtain sufficient competent audit evidence.

.140 In rare circumstances, the auditor's understanding of internal control may raise doubts about the auditability of an entity's financial statements. Concerns about the integrity of the entity's management may be so serious as to cause 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 it is unlikely that sufficient appropriate audit evidence will be available to support an opinion on the financial statements.

.141 If the auditor concludes that it is unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion on the financial statements, the auditor should consider a qualification or disclaimer of opinion. In some cases, the auditor's only recourse may be to withdraw from the engagement.

Practical Guidance

Readers may refer to appendix M, "Illustrative Audit Documentation Case Study: Young Fashions, Inc.," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* for examples of how to document your understanding of internal control. Appendix M contains several subappendixes (appendix M-1–M-6). Those that are particularly relevant to internal control include the following:

- Appendix M-2, "Young Fashions: Evaluation of Entity–Level Controls," provides example documentation of the auditors evaluation of entity-level controls, except for IT general controls. Appendix M-2 illustrates how to document your understanding of the controls relevant to the audit, including (1) an evaluation of whether the design of the control, individually or in combination, is capable of effectively preventing or detecting and correcting material misstatements and (2) a determination of whether the control exists and the entity is using it.
- Appendix M-2-1, "Young Fashions: Procedures Performed to Evaluate Entity-Level Controls," provides illustrative documentation for the risk assessment and other procedures an auditor performs to obtain the required understanding about internal control and the source of that understanding.
- Appendix M-3, "Young Fashions: Understanding of Internal Control—IT General Controls," provides example documentation of the auditors evaluation of IT general controls.
- Appendix M-4, "Young Fashions: Evaluation of Activity-Level Controls—Wholesale Sales," provides example documentation of an evaluation of activity-level controls. This case study presents only one class of transactions, sales. In practice, the auditor would evaluate activity-level controls for each significant class of transactions.

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[2] Control risk may be assessed in quantitative terms, such as percentages, or in qualitative terms such as high, medium, or low risk.

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AAM Section 5000
Designing and Performing Further Audit Procedures

> The material included in these sections on designing and performing further audit procedures is presented for illustrative purposes only. The nature, extent, and timing of the auditing procedures to be applied on a particular engagement are a matter of professional judgment to be determined by the auditor based on the assessed risks of material misstatement.
>
> This manual is a nonauthoritative practice aid. Users of this manual are urged to refer directly to applicable authoritative pronouncements when appropriate. Please also note that this manual does not deal with specialized industry issues; refer to applicable AICPA Audit and Accounting Guides for industry guidance.

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AAM Section 5100

Designing Further Audit Procedures

Audit Procedures for Obtaining Audit Evidence

.01 In order to draw reasonable conclusions on which to base the audit opinion, auditors should obtain audit evidence by performing audit procedures to

- obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels (audit procedures performed for this purpose are referred to as *risk assessment procedures*);
- when necessary or when the auditor has determined to do so, test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *tests of controls*); and
- detect material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *substantive procedures* and include tests of details of classes of transactions, account balances, and disclosures, and substantive analytical procedures).

.02 The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

.03 Tests of controls are necessary in two circumstances. When the auditor's risk assessment includes an expectation of the operating effectiveness of controls, the auditor should test those controls to support the risk assessment. In addition, when the substantive procedures alone do not provide sufficient appropriate audit evidence, the auditor should perform tests of controls to obtain audit evidence about their operating effectiveness. See section 5200, "Performing Tests of Controls," for additional guidance on performing tests of controls.

.04 As described in AU section 318, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained* (AICPA, *Professional Standards*), the auditor should plan and should perform substantive procedures to be responsive to the related planned level of detection risk, which includes the results of tests of controls, if any. The auditor's risk assessment is judgmental, however, and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations in internal control, including the risk of management override, the possibility of human error, and the effect of systems changes. Therefore, regardless of the assessed risks of material misstatement, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure to obtain sufficient appropriate audit evidence. See section 5300, "Performing Substantive Procedures," for additional guidance on performing substantive procedures.

Linking the Assessed Risks to the Design of Further Audit Procedures

.05 As discussed in section 3130, "Assessing the Risks of Material Misstatement," the auditor's risk assessment process culminates with the articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur and—even more specifically—how the misstatements may occur and the assertions that are likely to be misstated. This assessment of the risks of

misstatement, which relates identified financial reporting risks to what can go wrong at the assertion level, provides a basis for the design of further audit procedures.

.06 To reduce audit risk to an acceptably low level, the auditor should determine overall responses to address the assessed risks of material misstatement at the financial statement level and should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The overall responses and the nature, timing, and extent of the further audit procedures to be performed are matters for the professional judgment of the auditor.

Overall Responses to Risks at the Financial Statement Level

.07 The auditor's audit response to financial statement level risks should be responsive to the assessed risk. The same is true for responses to risk at the account, assertion level, or both. It is critical that the auditor's audit procedures are linked clearly and responsive to the assessment. This linkage between risk assessment and audit procedures is part of the audit strategy and audit plan, and it should be documented. The following paragraph describes some important characteristics of financial statement level risks. The purpose of these descriptions is to help the auditor bridge between the assessment of financial statement level risks and the subsequent response.

.08 Characteristics of financial statement level risks that are relevant for audit purposes include the following:

- *Financial statement level risks can affect many assertions*. By definition, financial statement level risks may result in material misstatements of several accounts or assertions. For example, a lack of controls over journal entries increases the risk that an inappropriate journal entry could be posted to the general ledger as part of the period-end financial reporting process. The posting of an inappropriate journal entry may not be isolated to one general ledger account but potentially could affect any account. In general, overall audit risk increases when the magnitude or scope of an identified risk of misstatement is not known.
- *Assessing financial statement-level risks requires significant judgment*. Ultimately, the auditor relates identified risks of misstatement to what can go wrong. For example, suppose that while performing risk assessment procedures to gather information about the control environment, the auditor discovered weaknesses relating to the hiring, training, and supervision of entity personnel. These weaknesses result in an increased risk of a misstatement of the financial statements, but it will be a matter of the auditor's professional judgment to determine the following:
  - — The accounts and relevant assertions that could be affected
  - — The likelihood that a financial statement misstatement will result from the increased risks
  - — The significance of any misstatement
- *Risks at the Financial Statement Level May Not be Identifiable With Specific Assertions*. Control weaknesses at the financial statement level can render well-designed activity-level controls ineffective. For example, a significant risk of management override can potentially negate existing controls and procedures at the activity level in many accounts and for many assertions. Linking such a risk to specific accounts and assertions may be very difficult and may not even be possible. As another example, a client may have excellent data input controls at the application level. But if poorly designed IT general controls allow many unauthorized personnel the opportunity to access and inappropriately change the data, the well-designed input controls have been rendered ineffective. Also, strengths in financial statement-level controls such as an overall culture of ethical behavior may increase the reliability of controls that operate at the activity level. Determining the extent to which financial statement level controls affect the reliability of specific activity level controls (and, therefore, the assessment of the risks of material misstatement) is subjective and may vary from client to client.

.09 Due to the unique characteristics of financial statement level risks, it may not be possible to correlate all of these risks to a finite set of assertions. For example, a weakness in control environment may affect all

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or mostly all of the accounts, classes of transactions, or disclosures and the relevant assertions. To respond appropriately to these types of financial statement level risks, the auditor may need to reconsider the overall approach to the engagement. The following paragraph provides examples of overall responses to risks at the financial statement level that have a pervasive effect on the financial statements and cannot necessarily be mapped to individual assertions.

.10 The auditor's overall responses to address the assessed risks of material misstatement at the financial statement level may include the following:

- Emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence.
- Assigning more experienced staff or those with specialized skills or using specialists.
- Providing more supervision.
- Incorporating additional elements of unpredictability in the selection of further audit procedures to be performed and in selecting individual items for testing.
- Making general changes to the nature, timing, or extent of further audit procedures as an overall response, for example, performing substantive procedures at period end instead of at an interim date. One could also focus more time and attention on audit areas more closely associated with the risks.

.11 The assessment of the risks of material misstatement at the financial statement level is affected by the auditor's understanding of the control environment. An effective control environment may allow the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity and thus, for example, allow the auditor to perform some audit procedures at an interim date rather than at period end. If there are weaknesses in the control environment, the auditor should consider an appropriate response. For example, the auditor could perform audit procedures as of the period end rather than at an interim date, seek more extensive audit evidence from substantive procedures, modify the nature of audit procedures to obtain more persuasive audit evidence, or increase the number of locations to be included in the audit scope.

.12 Such considerations, therefore, have a significant bearing on the auditor's general approach, for example, an emphasis on substantive procedures (substantive approach) or an approach that uses tests of controls as well as substantive procedures (combined approach).

.13 Paragraphs .13 and .50 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), describe the overall responses the auditor may take in response to his or her assessment of the risk of material misstatement due to fraud. When determining an overall audit response, the auditor may consider the assessment of fraud risk concurrently with the assessment of the risks of material misstatement due to error. The auditor can develop one overall response that is appropriate for both kinds of risks.

Audit Procedures Responsive to Risks of Material Misstatement at the Relevant Assertion Level

.14 Further audit procedures provide important audit evidence to support the auditor's audit opinion. These procedures consist of tests of controls and substantive tests.

.15 The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the relevant assertion level. The purpose is to provide a clear linkage between the nature, timing, and extent of the auditor's further audit procedures and the risk assessments.

.16 In designing further audit procedures, the auditor should consider such matters as the following:

- The significance of the risks and the likelihood that a material misstatement will occur. In general, the more significant (in terms of likelihood and magnitude) the risks the more reliable and relevant audit evidence should be.
- The characteristics of the class of transactions, account balance, or disclosure involved, which will help determine the nature, timing, and extent of procedures available to the auditor. For example, the gross accounts receivable balance comprises transactions with third parties, which means the auditor can contact these external parties to confirm the transactions or individual account balances. On the other hand, the allowance for doubtful accounts is an estimate prepared internally, which does not lend itself to confirmation but to other substantive tests.
- The nature of the specific controls used by the entity, in particular, whether they are manual or automated.
- Whether the auditor expects to obtain audit evidence to determine if the entity's controls are effective in preventing or detecting material misstatements.

The nature of the audit procedures is of most importance in responding to the assessed risks.

.17 The auditor's assessment of the identified risks at the relevant assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures. In some cases, the auditor may determine that performing only substantive procedures is appropriate for specific relevant assertions and risks. In those circumstances, the auditor may exclude the effect of controls from the relevant risk assessment. This may be because the auditor's risk assessment procedures have not identified any effective controls relevant to the assertion or because testing the operating effectiveness of controls would be inefficient. However, the auditor needs to be satisfied that performing only substantive procedures for the relevant assertions would be effective in reducing detection risk to an acceptably low level. The auditor often will determine that a combined audit approach using both tests of the operating effectiveness of controls and substantive procedures is an effective audit approach.

.18 Regardless of the audit approach selected, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Because effective internal controls generally reduce, but do not eliminate, risks of material misstatement, tests of controls reduce, but do not eliminate, the need for substantive procedures. In addition, analytical procedures alone may not be sufficient in some cases. For example, when auditing certain estimation processes such as examining the allowance for doubtful accounts, the auditor may perform substantive procedures beyond analytical procedures (for example, examining cash collections subsequent to period end) due to the risk of management override of controls or the subjectivity of the account balance.

.19 In the case of very small entities, there may not be many control activities that could be identified by the auditor. For this reason, the auditor's further audit procedures are likely to be primarily substantive procedures. In such cases, in addition to the matters referred to in the preceding paragraph .16, the auditor should consider whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

Nature of Further Audit Procedures

.20 The nature of further audit procedures refers to the following:

- Their purpose, that is, tests of controls or substantive procedures (or dual purpose tests) and whether they are designed to test for overstatement, understatement, or both
- Their type, such as the following:
  - Inspection
  - Observation

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— Inquiry

— Confirmation

— Recalculation

— Reperformance

— Analytical procedures (including scanning)

Table 1 provides additional guidance on each of these procedures.

Table 1
Types of Audit Procedures

Type of Procedure	*Definition*	*Additional Guidance*
Inspection of documents	Inspection of documents involves examining records or documents, whether internal or external, in paper form, electronic form, or other media.	• This procedure provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal documents, on the effectiveness of the controls over their production. • Some documents represent direct audit evidence of the existence of an asset but not necessarily about ownership or value. • Inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting principles, such as revenue recognition. • Some forms of documents are less persuasive than others. For example, faxes and copies may be less reliable than original documents.
Inspection of tangible assets	Inspection of tangible assets consists of physical examination of the assets.	• This procedure may provide audit evidence relating to existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. • Inspection of individual inventory items ordinarily accompanies the observation of inventory counting.
Observation	Observation consists of looking at a process or procedure being performed by others.	• This procedure provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed.

(continued)

Type of Procedure	*Definition*	*Additional Guidance*
Confirmation	Confirmation is the process of obtaining a representation of information or of an existing condition directly from a knowledgeable third party.	• This procedure — frequently is used in relation to account balances and their components but need not be restricted to these items; — can be designed to ask if any modifications have been made to an agreement, and if so, what the relevant details are; and — also is used to obtain audit evidence about the absence of certain conditions (for example, the absence of an undisclosed agreement that may influence revenue recognition). • See AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*), for further guidance on confirmations.
Recalculation	Recalculation consists of checking the mathematical accuracy of documents or records.	• This procedure can be performed through the use of information technology, for example, by applying a data extraction application or other computer assisted audit techniques (CAATs).
Reperformance	Reperformance is the auditors independent execution of procedures or controls that were originally performed as part of the entity's internal control	• This procedure may be performed either manually or through the use of CAATs, for example, reperforming the aging of accounts receivable.

Inquiry

.21 Inquiry consists of seeking information of knowledgeable individuals. These individuals may be involved in the financial reporting process or outside of that process; they may be internal or external to the company. Inquiry is used extensively throughout the audit and often is complementary to other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Asking questions of knowledgeable individuals is only part of the inquiry process. Evaluating the responses to inquiries is an equally integral part of the process.

.22 Inquiry normally involves such actions as the following:

- Considering the knowledge, objectivity, experience, responsibility, and qualifications of the individual to be questioned
- Asking clear, concise, and relevant questions
- Using open or closed questions appropriately
- Listening actively and effectively
- Considering the reactions and responses and asking follow-up questions
- Evaluating the response

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See appendix K, "Suggestions for Conducting Inquiries," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* for further guidance on performing inquiries.

.23 Responses to inquiries may provide the auditor with information he or she did not previously possess or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information the auditor has obtained, such as information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures. The auditor should resolve any significant inconsistencies in the information obtained.

.24 The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.

.25 In some instances, the auditor may need to obtain evidence about management's intended actions, for example, when obtaining evidence to support management's classification of investments as either trading, available for sale, or hold to maturity. To corroborate management's responses to questions regarding their intended future action, the following may provide relevant information:

- Management's past history of carrying out its stated intentions with respect to assets and liabilities
- Management's stated reasons for choosing a particular course of action
- Management's ability to pursue a specific course of action

.26 In some cases, the auditor should obtain replies to inquiries in the form of written representations from management. For example, when obtaining oral responses to inquiries, the nature of the response may be so significant that it warrants obtaining written representation from the source. See AU section 333, *Management Representations* (AICPA, *Professional Standards*), for further guidance on written representations.

Substantive Analytical Procedures

.27 Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. Analytical procedures are used for the following purposes:

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

b. As risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control

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

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

.28 Analytical procedures can be effective

- for certain types of assertions (for example, the completeness assertion, which cannot be tested directly using a test of balances on recorded amounts).
- when the relationships between amounts are very predictable.
- when the data used to develop expectations based on the relationship are reliable.
- when relatively precise expectations can be developed.

.29 Analytical procedures can provide evidence supporting financial statement assertions and, thus, can be used as substantive tests. Because analytical procedures are often the least expensive tests, they may be used whenever practical.

.30 Paragraph .05 of AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), describes analytical procedures as follows:

> Analytical procedures involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor. The auditor develops such expectations by identifying and using plausible relationships that are reasonably expected to exist based on the auditor's understanding of the client and of the industry in which the client operates. Following are examples of sources of information for developing expectations:
>
> *a.* Financial information for comparable prior period(s) giving consideration to known changes
>
> *b.* Anticipated results—for example, budgets, or forecasts including extrapolations from interim or annual data
>
> *c.* Relationships among elements of financial information within the period
>
> *d.* Information regarding the industry in which the client operates—for example, gross margin information
>
> *e.* Relationships of the financial information with relevant nonfinancial information

.31 Whenever analytical procedures are applied as substantive tests, the auditor may apply the following procedures:

- Consider whether the relationship is plausible and predictable.
- Consider whether the data used for the comparison is reliable.
- Consider whether the account balance tested is consistent with the auditor's expectations. If it is not consistent, obtain the client's explanation for the variance and get evidence to corroborate the client's explanation.

.32 AU section 329 states that analytical procedures should be performed in the planning and overall review stages of all audits. See AU section 329 and section 3155, "Analytical Procedures," for further guidance on analytical procedures.

The Selection of Audit Procedures

.33 The auditor's selection of audit procedures is based on the risks of material misstatement. The higher the auditor's assessment of risk, the more reliable and relevant the audit evidence sought by the auditor from substantive procedures is. This determination of the requisite reliability and relevance of audit evidence may affect both the types of audit procedures to be performed and their combination. For example, the auditor may confirm the completeness of the terms of a contract with a third party, in addition to inspecting the document and obtaining management's representation. This combination of several procedures would result in more reliable and relevant audit evidence than obtained by performing only one procedure.

.34 In determining the audit procedures to be performed, the auditor should consider the underlying reasons for the assessment of the risks of material misstatement at the relevant assertion level for each class of transactions, account balance, and disclosure. These underlying reasons relate to both the inherent and control risks related to the assertion. For example, if the auditor assessed risks of material misstatement to be low that a material misstatement might occur because of low inherent risk, the auditor may determine that substantive analytical procedures alone may provide sufficient appropriate audit evidence. On the other hand, if the auditor expects that there are lower risks of material misstatement because the client has effective controls and the auditor intends to design substantive procedures based on relying on the effective operation

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of those controls, then the auditor should perform tests of controls to obtain audit evidence about their operating effectiveness.

.35 The auditor should obtain audit evidence about the accuracy and completeness of information produced by the entity's information system when that information is used in performing audit procedures. For example, if the auditor uses nonfinancial information or budget data produced by the entity's information system in performing audit procedures, such as substantive analytical procedures or tests of controls, the auditor should obtain audit evidence about the accuracy and completeness of such information.

Timing of Further Audit Procedures

.36 Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies. The auditor may perform tests of controls or substantive procedures

- at an interim date.
- at period end.
- after period end, in those instances where the procedure cannot be performed prior to or at year end (for example, agreeing the financial statements to the accounting records).

.37 The higher the risks of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer to or at the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times (for example, performing audit procedures at selected locations on an unannounced basis). On the other hand, performing audit procedures before the period end may assist the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters. If the auditor performs tests of the operating effectiveness of controls or substantive procedures before period end, the auditor should consider the additional evidence that is necessary for the remaining period.

.38 In considering when to perform audit procedures, the auditor should also consider such matters as the following:

- The assessed risks of misstatement. In general, the higher the risk, the more likely it is that the auditor will perform procedures nearer to or at the period end.
- The control environment. In general, the more effective the control environment, the more likely it is that the auditor will be able to perform tests as of an interim date.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risks (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the auditor may examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

Extent of Further Audit Procedures

.39 Extent refers to the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgment of the auditor after considering the following:

- Tolerable misstatement
- Assessed risk of material misstatement
- Degree of assurance the auditor plans to obtain

.40 In particular, the auditor may increase the extent of audit procedures as the risks of material misstatement increase. However, increasing the extent of audit procedures is effective only if the audit procedures themselves are relevant to the specific risks and reliable; therefore, the nature of the audit procedure is the most important consideration.

.41 The AICPA Audit Guide *Audit Sampling* provides additional guidance on sampling for substantive testing.

Documentation

.42 The auditor should document the overall responses to address the assessed risks of misstatement at the financial statement level and the linkage of those procedures with the assessed risks at the relevant assertion level. The manner in which these matters are documented is based on the auditor's professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

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AAM Section 5200

Performing Tests of Controls

.01 The auditor should perform tests of controls when the auditor's risk assessment[1] includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the relevant assertion level.

.02 When, in accordance with paragraph .117 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor has determined that it is not possible or practicable to reduce the detection risks at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, he or she should perform tests of controls to obtain audit evidence about their operating effectiveness. For example, as discussed in paragraphs .119–.120 of AU section 314, the auditor may find it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the relevant assertion level when an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system.

.03 Tests of the operating effectiveness of controls are performed only on those controls that the auditor has determined are suitably designed to prevent or detect a material misstatement in a relevant assertion. Paragraphs .106–.108 of AU section 314 discuss the identification of controls at the relevant assertion level likely to prevent or detect a material misstatement in a class of transactions, account balance, or disclosure.

.04 Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor should determine that the relevant controls exist and that the entity is using them. When performing tests of controls, the auditor should obtain audit evidence that controls operate effectively. This includes obtaining audit evidence about

- how controls were applied at relevant times during the period under audit,
- the consistency with which they were applied, and
- by whom or by what means they were applied.

If substantially different controls were used at different times during the period under audit, the auditor should consider each separately. The auditor may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

General Considerations When Testing Controls

Sources of Audit Evidence About Internal Control Effectiveness

.05 The audit evidence used to provide support for the auditor's conclusion about the operating effectiveness of controls during the audit period may come from a variety of sources, including the following:

- Tests of controls performed during the current period.
- Risk assessment procedures performed during the current period.

[1] The auditor's strategy reflects the level of assurance the auditor plans to obtain regarding controls.

- Evidence provided in a type 2 Statement on Auditing Standards (SAS) No. 70 report (see AU section 324, *Service Organizations* [AICPA, *Professional Standards*]).[*]
- Evidence obtained from the performance of procedures in previous audits.
- The information gathered and conclusions reached as part of the auditor's quality control procedures for client acceptance and continuance. For example, client acceptance procedures may include inquiries of attorneys, bankers, or others in the business community about client management that provide insight into their
  - — competence,
  - — integrity,
  - — operating philosophy, and
  - — ethical values.

Risk Assessment Procedures Versus Tests of Controls

.06 Risk assessment procedures allow the auditor to evaluate the design effectiveness of internal control for the purpose of assessing risks of material misstatement. Tests of controls build on the auditor's evaluation of design effectiveness and allow the auditor to assess the operating effectiveness of controls during the operating period. The results of the auditor tests of controls are used to design substantive procedures.

.07 Although some risk assessment procedures that the auditor performs to evaluate the design of controls and to determine that they have been implemented may not have been specifically designed as tests of controls, they may nevertheless provide audit evidence about the operating effectiveness of the controls and, consequently, serve as tests of controls. For example, a walkthrough or the observation of the performance of a control may provide evidence about the operating effectiveness of controls. In such circumstances, the auditor should consider whether the audit evidence provided by those audit procedures is sufficient.

Evidence of Operating Effectiveness of Controls at a Service Organization[*]

.08 A Type 2 service auditor's report may provide evidence about the operating effectiveness of controls at a service organization. However, controls over the information provided to the service organization may still need to be assessed. Chapter 6, "Performing Further Audit Procedures," of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* provides additional guidance on evaluating the operating effectiveness of controls at a service organization.

Evaluating the Effectiveness of Complementary Controls

.09 When designing tests of controls, typically the auditor will focus first on testing control activities, because the control activities component of internal control is the one most directly related to the assertion. For example, physically counting goods that have been received and comparing the quantity and description to the vendor's packing slip is directly related to both the existence and valuation of inventory.

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[*] The Auditing Standards Board (ASB) has issued Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), which will replace the guidance contained in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), for a service auditor when reporting on controls at an organization that provides service to user entities when those controls are likely to be relevant to user entities' internal controls over financial reporting. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation is permitted; therefore, if adopting SSAE No. 16 early, refer directly to the standard as certain guidance in this manual may not be applicable.

In addition, the ASB has released Statement on Auditing Standards (SAS) *Audit Considerations Relating to an Entity Using a Service Organization*, which when issued will supersede the current requirements and guidance for user auditors in SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324). This SAS has been released but not yet issued as authoritative. Upon the finalization of all remaining SASs to be issued as part of the Clarity Project, one SAS will be issued containing all clarified SASs in codified format. The effective date of the SAS containing all clarified SASs is expected to be for audits of financial statements for periods ending on or after December 15, 2012, unless otherwise established. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324. Readers should be alert to the issuance of the final SAS. The SAS can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/DownloadableDocuments/Clarified_SASs/Clarified%20SAS%20Service%20Organizations_Effective%20Date%20Change_Clean.pdf. Additional information on the ASB's Clarity Project can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx.

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.10 However, in addition to testing the controls that relate directly to the assertion, the auditor should consider the need to obtain audit evidence supporting the effective operation of the complementary controls upon which the effectiveness of the direct control depends.

.11 When considering the need to test complementary controls, the auditor should consider the following:

- *The significance of the complementary control to the effective functioning of the direct control.* As the effectiveness of the direct control becomes more dependent on the complementary control, the auditor's need to test the complementary control increases.
- *The relative significance of the audit evidence of the complementary control to the auditor's conclusion on the effectiveness of the direct control.* The auditor's conclusion about the operating effectiveness of a control activity is supported by a combination of evidence about (i) the operating effectiveness of the direct control activity itself and (ii) the operating effectiveness of other, complementary controls upon which the effectiveness of the direct control depends. In some instances, the auditor may be able to support a conclusion based primarily on tests of the direct control, with little evidence about the operating effectiveness of the related complementary controls. In other instances (for example, IT application controls), the auditor's conclusion may be based primarily on tests of the complementary controls and little on tests of the direct control. In those situations where you rely significantly on the operating effectiveness of the complementary control, the auditor might obtain more sufficient and adequate audit evidence to support the conclusion on the operating effectiveness of the indirect control, for example, the monitoring of the performance of the reconciliation.
- *The degree of reliability required of the audit evidence obtained about internal control operating effectiveness.* Testing the complementary control increases the reliability of the audit evidence obtained about the operating effectiveness of the direct control. For example, the auditor may test 4 month-end reconciliations and draw a conclusion about the effectiveness of those reconciliations for an entire 12-month period. If the auditor has tested the operating effectiveness of the complementary controls related to the reconciliation, the conclusion about the effectiveness of the reconciliation during the period the auditor did not test will be more reliable than if the auditor did not test the complementary controls.
- *Evidence of operating effectiveness that may have been obtained as part of obtaining an understanding of the design and implementation of the complementary controls.* When performing risk assessment procedures to obtain an understanding of internal control, the auditor may obtain some information about the operating effectiveness of the complementary controls that are indirectly related to an assertion. For example, risk assessment procedures may provide the auditor with some evidence about the operating effectiveness of portions of the control environment. This information about operating effectiveness may be limited, but nevertheless, it may be sufficient for the purpose of drawing a conclusion about the operating effectiveness of the direct control.

.12 When testing complementary controls, the auditor may choose not to test the operating effectiveness of the entire component to which the complementary control pertains, but may limit the tests to those elements of the component that have an immediate bearing on the effectiveness of the direct control. For example, when testing controls over purchasing to place moderate reliance on them, the auditor may consider the need to test the control environment or IT general controls relating to the entire entity beyond the design and implementation assessment procedures the auditor already has performed. If practical, the auditor may limit the tests to those aspects of the control environment or IT general controls that have a direct bearing on the financial statement assertions related to purchasing. To place high reliance on the controls, the auditor may often need to gather additional evidence concerning the IT general controls and overall control environment to support high reliance on the purchasing controls.

The Relationship Between Tests of Controls and Substantive Tests

.13 There is an inverse relationship between the audit evidence to be obtained from substantive tests and that obtained from tests of controls. As the sufficiency and adequacy of the audit evidence obtained from tests of controls increases, the sufficiency and adequacy of the audit evidence required from substantive tests generally decreases. For example, in circumstances when the auditor adopts an approach consisting primarily

of tests of controls, in particular related to those risks where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures, the auditor should perform tests of controls to obtain a high level of assurance about their operating effectiveness.

.14 On the other hand, the more audit evidence that can be obtained from substantive tests, the less audit evidence would be necessary from tests of controls. In many instances, the nature and extent of substantive tests alone may provide sufficient, adequate evidence at the assertion level, which would make the testing of control effectiveness (beyond assessing the design and implementation of the related controls) unnecessary.

A Financial Statement Audit Versus An Examination of Internal Control

.15 Testing the operating effectiveness of internal control to support an opinion on the financial statements is different from testing controls to support an opinion on the effectiveness of the internal control system.

.16 In an attestation engagement to examine the effectiveness of internal control, the audit evidence obtained from the tests of internal control is the only evidence the auditor has to support an opinion. In contrast, when performing an audit of the financial statements, the auditor ordinarily performs both tests of controls and substantive tests. The objective of the tests of controls in a financial statement audit is to assess the operating effectiveness of controls and incorporate this assessment into the design of the nature, timing, and extent of substantive procedures. Thus, when testing controls in a financial statement audit, the auditor has flexibility in determining not only whether to test controls, and if so which controls to test, but also the level of effectiveness of those controls that is necessary to provide the desired level of support for an opinion on the financial statements.

Determining the Nature of the Tests of Controls

.17 The nature of the procedures the auditor performs to test controls has a direct bearing on the relevance and reliability of audit evidence. When responding to assessed risks of material misstatement, the nature of the audit procedures is of most importance. Performing more tests or conducting the tests closer to the period end will not compensate for a poorly designed test that lacks sufficient relevance or reliability in gathering audit evidence about the effectiveness of a control.

.18 The types of audit procedures available for obtaining audit evidence about the effectiveness of controls includes the following:

- Inquiries of appropriate entity personnel
- Inspection of documents, reports, or electronic files indicating performance of the control
- Observation of the application of the control
- Reperformance of the application of the control by the auditor

.19 The nature of the particular control influences the type of audit procedure necessary to obtain audit evidence about operating effectiveness. Documentation may provide evidence about the performance of some controls; in these situations, the auditor may inspect this documentation to obtain evidence about the operating effectiveness of the control.

.20 For other controls, complete documentation may not be available or relevant. For example, documentation of the operation may be sketchy for some factors in the control environment, such as assignment of authority and responsibility, or for some types of control activities, such as control activities performed automatically by the client's IT system. In these circumstances, audit evidence about operating effectiveness may be obtained through inquiry in combination with other audit procedures such as observation of the performance of the control or the use of computer assisted audit techniques. Entities should be encouraged to improve weak documentation.

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.21 Because of the limits of inquiry and observation, inquiry combined with inspection or reperformance ordinarily provide more reliable audit evidence than a combination of only inquiry and observation. For example, the auditor may inquire about and observe the entity's procedures for opening the mail and processing cash receipts to test the operating effectiveness of controls over cash receipts. Because an observation is pertinent only at the point in time at which it is made, the auditor may supplement the observation with other observations or inquiries of entity personnel, and the auditor may also inspect documentation about the operation of such controls at other times during the audit period.

Tests of IT Controls

.22 Because of the inherent consistency of IT processing, audit evidence about the implementation of an automated control, combined with audit evidence about the operating effectiveness of IT general controls (and in particular, security and change controls) may provide substantial audit evidence about the operating effectiveness of the control during the entire audit period. That is, once the auditor has determined that an IT application control has been implemented (placed in operation), the auditor may draw a conclusion about the operating effectiveness of the IT portion of the control activity, so long as the auditor has determined that relevant IT general controls are operating effectively.

Tests of Spreadsheets

.23 The development and use of spreadsheets typically lack the controls that usually are present for formal, purchased software. Absent audit evidence indicating that appropriate general controls over spreadsheets have been implemented, the auditor might continue to test spreadsheet controls even after their implementation.

Dual Purpose Tests

.24 Some audit procedures may simultaneously provide audit evidence that both

- support the relevant assertion or detects material misstatement and
- support a conclusion about the operating effectiveness of related controls.

Tests that achieve both of these objectives concurrently on the same transaction typically are referred to as dual purpose tests. For example, the auditor may examine an invoice to determine whether it has been approved and also to provide substantive audit evidence about the existence and amount of the transaction.

.25 When performing a dual purpose test, the auditor should carefully consider whether the design and evaluation of such tests can accomplish both objectives. For example, the population of controls and the population of substantive procedures should be the same. If tests on components of a balance such as receivables are designed as dual purpose tests, only evidence of the controls operating over period-end balance items will be obtained.

.26 Furthermore, when performing such tests, the auditor should consider how the outcome of the tests of controls may affect the auditor's determination about the extent of substantive procedures to be performed. For example, if controls are found to be ineffective, the auditor should consider whether the sample size for substantive procedures should be increased from that originally planned.

Determining the Timing of Tests of Controls

.27 The timing of tests of controls affects the relevance and reliability of the resulting audit evidence. In general, the relevance and reliability of the audit evidence obtained diminishes as time passes between the testing of the controls and the end of the period under audit. For this reason, when tests of controls are performed during an interim period or carried forward from a previous audit, the auditor should determine what additional audit evidence should be obtained to support a conclusion on the current operating effectiveness of those controls.

.28 The timing of tests of controls depends on the auditor's objective:

a. When controls are tested as of a point in time, the auditor may obtain audit evidence that the controls operated effectively only at that time.

b. When controls are tested throughout a period, the auditor may obtain audit evidence of the effectiveness of the operation of the control during that period.

.29 Audit evidence pertaining only to a point in time may be sufficient for the auditor's purpose, for example, when testing controls over the client's physical inventory counting at the period end. If, on the other hand, the auditor needs audit evidence of the effectiveness of a control over a period, audit evidence pertaining only to a point in time may be insufficient, and the auditor should supplement those tests with others that provide audit evidence that the control operated effectively during the period under audit. For example, for an automated control, the auditor may test the operation of the control at a particular point in time. The auditor then may perform tests of controls to determine whether the control operated consistently during the audit period, or the auditor may test with the intention of relying on general controls pertaining to the modification and use of that computer program during the audit period.

.30 The tests the auditor performs to supplement tests of controls at a point of time may be part of the tests of controls over the client's monitoring of controls.

Updating Tests of Controls Performed During an Interim Period

.31 The auditor may test controls as of or for a period that ends prior to the balance sheet date. This date often is referred to as the *interim date* or *interim period*. The period of time between the interim date or period and the balance sheet date often is referred to as the *remaining period*.

.32 When the auditor tests controls during an interim period or as of an interim date, the auditor should

- obtain audit evidence about the nature and extent of any significant changes in internal control that occurred during the remaining period and
- determine what additional audit evidence should be obtained for the remaining period.

.33 To determine what additional audit evidence the auditor should obtain to update tests of controls performed in advance of the balance sheet date, the auditor should consider the following:

- The significance of the assessed risks of material misstatement at the relevant assertion level
- The specific controls that were tested during the interim period
- The degree to which audit evidence about the operating effectiveness of those controls was obtained
- The length of the remaining period
- The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls
- The control environment
- The volume or value of transactions processed in the remaining period

.34 The auditor may obtain additional audit evidence about the operating effectiveness of controls during the remaining period by performing procedures such as

- extending the testing of the operating effectiveness of controls over the remaining period or
- testing the client's monitoring of controls.

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.35 For example, the auditor might perform

- inquiries and observations related to the performance of the control, the monitoring of the control, or any changes to the control during the remaining period;
- a walkthrough covering the period between the interim date and the period end; and
- the same procedures performed at interim, but directed to the period from interim to period end.

Use of Audit Evidence Obtained in Prior Audits

.36 If certain conditions are met, the auditor may use audit evidence obtained in prior audits to support the conclusion about the operating effectiveness of controls in the current audit. If the auditor plans to use evidence obtained in prior periods, the auditor should consider

- whether the use of this evidence is appropriate and
- the length of the time period that may elapse before retesting the control.

.37 The following table summarizes the factors the auditor should consider when determining whether to use audit evidence about the operating effectiveness obtained in a prior audit.

	Appropriateness of Using Evidence From Prior Audit		*Length of Time Before Retesting Control*	
	May be appropriate	*May not be appropriate*	*Longer*	*Shorter*
Effectiveness of control environment, the client's risk assessment, monitoring, and IT general controls	Effective design and operation	Evidence of poor design or operation	Effective design and operation	Evidence of poor design or operation
Risks arising from characteristics of the control	Largely automated control	Significant manual or judgmental component to control	Largely automated control	Significant manual or judgmental component to control
Changes in circumstances at the client that may require changes in controls, including personnel changes that affect application of the control	Minor changes in client circumstances, including personnel	Significant changes in client circumstances, including personnel	Minor changes in client circumstances, including personnel	Significant changes in client circumstances, including personnel
Operating effectiveness of the control	Control operated effectively in prior audit	Control did not operate effectively in prior audit	Control operated effectively in prior audit	Control did not operate effectively in prior audit

(continued)

	Appropriateness of Using Evidence From Prior Audit		*Length of Time Before Retesting Control*	
	May be appropriate	*May not be appropriate*	*Longer*	*Shorter*
Risks of material misstatement	Low risk of material misstatement for relevant assertion	High risk of material misstatement for relevant assertion	Low risk of material misstatement for relevant assertion	High risk of material misstatement for relevant assertion
Extent of reliance on the control to design substantive procedures	Low reliance on the control	High reliance on the control	Low reliance on the control	High reliance on the control

.38 If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should

- obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit and
- perform audit procedures to establish the continuing relevance of audit evidence obtained in the prior audit.

.39 Even when the auditor uses audit evidence about the operating effectiveness of controls obtained in prior periods, the auditor still should evaluate the design effectiveness and implementation of controls in the current period. The procedures performed as described in the preceding paragraph may help the auditor fulfill this responsibility; however, the auditor may have to supplement these procedures with others. For example, if the controls have not changed from the previous period but the client's business process has, the auditor will need to determine whether the design of controls remains effective in light of the changed business processes.

.40 The auditor may not rely on audit evidence about the operating effectiveness of controls obtained in prior audits for controls that

- have changed significantly since the prior audit,
- pertain to business processes that have changed significantly since the prior audit, and
- mitigate significant risks.

For any control that meets one of the preceding criteria, the auditor should test operating effectiveness in the current audit.

.41 For example, changes in a system that enable an entity to receive a new report from the system probably is not a significant change and, therefore, is unlikely to affect the relevance of prior period audit evidence. On the other hand, a change that causes data to be accumulated or calculated differently probably is significant and, therefore, does affect the relevance of audit evidence obtained in the prior period, in which case the operating effectiveness of the control should be tested in the current period.

Rotating Emphasis on Tests of Controls

.42 When the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of these controls at least once in every third year in an annual audit. There also may be some controls, such as over revenue recognition or inventories that, due to their importance to the client financial statements, might be subject to testing every two years or every year, depending on the risks, even when there are purported to be no changes in controls.

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.43 When there are a number of controls for which the auditor plans to use audit evidence obtained in prior audits, the auditor should test the operating effectiveness of *some* controls each audit. However, when the auditor is testing controls for only one or two key classes of transactions in an entity, rotating the testing of these controls may not be warranted.

Determining the Extent of Tests of Controls

.44 The extent of the auditor's tests of controls affects the sufficiency of the audit evidence obtained to support the auditor's assessment of the operating effectiveness of controls. To reduce the extent of substantive procedures in an audit, the tests of controls performed by the auditor need to be sufficient to determine the operating effectiveness of the controls

- at the relevant assertion level and
- either throughout the period, or as of the point in time when the auditor plans to rely on the control.

.45 Factors the auditor may consider in determining the extent of tests of controls include the following:

- The frequency of the performance of the control by the entity during the period.
- The length of time during the audit period that the auditor is relying on the operating effectiveness of the control.
- The relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects, material misstatements at the relevant assertion level.
- The extent to which audit evidence is obtained from tests of other controls that meet the same audit objective.
- The extent to which the auditor plans to rely on the operating effectiveness of the control in the assessment of risk (and thereby reduce substantive procedures based on the reliance of such control). The more the auditor relies on the operating effectiveness of controls in the assessment of risk, the greater is the extent of the auditor's tests of controls.
- The expected deviation from the control.

Sampling Considerations

.46 The auditor should consider using an audit sampling technique to determine the extent of tests whenever the control is applied on a transaction basis (for example, matching approved purchase orders to supplier invoices) and that it is applied frequently. When a control is applied periodically (for example, monthly reconciliations of accounts receivable subsidiary ledger to the general ledger), the auditor should consider guidance appropriate for testing smaller populations (for example, testing the control application for two months and reviewing evidence the control operated in other months or reviewing other months for unusual items). AU section 350, *Audit Sampling* (AICPA, *Professional Standards*), and the AICPA Audit Guide *Audit Sampling* provide further guidance on the application of sampling techniques to determine the extent of testing of controls. The AICPA Audit Guide *Audit Sampling* also provides guidance for testing in smaller populations.

.47 The auditor should consider the expected deviation from the control when determining the extent of tests. As the rate of expected deviation from a control increases, the auditor should increase the extent of testing of the control. However, if the rate of expected deviation is expected to be too high, the auditor may determine that tests of controls for a particular assertion may not be effective. In this case, the auditor may conclude that a deficiency in internal control exists and the auditor should consider its severity and whether it should be communicated to those charged with governance, management, or both.

Extent of Testing IT Controls

.48 Generally, IT processing is inherently consistent. An automated control should function consistently unless the program (including the tables, files, or other permanent data used by the program) is changed. Therefore, the auditor may be able to limit the testing of an IT application control to one or a few instances of the control operation, provided that the auditor determines that related IT general controls operated effectively during the period of reliance.

Assessing the Operating Effectiveness of Controls

Evidence About Operating Effectiveness

.49 The concept of effectiveness of the operation of controls recognizes that some deviations in the way a client applies the controls may occur. Deviations from prescribed controls may be caused by factors such as changes in key personnel, significant seasonal fluctuations in volume of transactions, and human error.

.50 When the auditor encounters deviations in the operation of controls, those deviations will have an effect on the auditor's assessment of operating effectiveness. A control with an observed nonnegligible deviation rate is not an effective control. For example, if a test is designed in which the auditor selects a sample of, say, 25 items and expects no deviations, the finding of 1 deviation would be considered a nonnegligible deviation because, based on the results of the test of the sample, the desired level of confidence has not been obtained.

.51 There are sources of audit evidence beyond the auditor's tests of controls that contribute to the auditor's assessment of the operating effectiveness of controls. The extent of misstatements detected by performing substantive procedures also may alter the auditor's judgment about the effectiveness of controls in a negative direction. However, misstatement-free results of substantive tests do not indicate that a lower assessment of control risk may be substituted for the one supported by the procedures the auditor used to assess control risk.

Investigating Additional Implications of Identified Deviations

.52 When the auditor detects control deviations during the performance of tests of controls, the auditor should make specific inquiries to understand these matters and their potential consequences, for example, by inquiring about the timing of personnel changes in key internal control functions.

.53 Deviations in the application of control activities may be caused by the ineffective operation of indirect controls such as IT general controls, the control environment, or other components of internal control. To gain an understanding of the deviations in control, the auditor may wish to make inquires and perform other tests to identify possible weaknesses in the control environment or other indirect controls.

.54 For example, suppose that one of the client's primary controls related to the existence of inventory—periodic test counts—had several instances where the number of items counted by the count teams did not agree to the actual physical count of the items on hand. When gaining a further understanding of the nature of these deviations, the auditor determines that the underlying cause is poor training of the test count teams and a lack of written instructions. Training and written instructions are indirect controls that may affect the operating effectiveness of controls other than those related to existence. For example, the lack of training and instruction could result in the count teams reporting the wrong product number or description, which also could affect the valuation of inventory. This finding could cause the company and auditor to conclude that a recount is necessary once the teams are properly trained.

Assessing Effectiveness

.55 After considering the results of tests of controls and any misstatements detected from the performance of substantive procedures, the auditor should determine whether the audit evidence obtained provides an

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appropriate basis for reliance on the controls. If the reliance on the controls is not warranted, the auditor should determine whether

- additional tests of controls are necessary or
- if the potential risks of misstatement will be addressed using substantive procedures.

Once the auditor has concluded that reliance on certain controls is not warranted, it is unnecessary to perform further tests of those controls.

Deficiencies in the Operation of Controls

.56 The auditor may consider whether deviations in the operation of controls have been caused by an underlying deficiency in internal control. When evaluating the reason for a control deviation, the auditor may consider the following:

- Whether the control is automated (in the presence of effective information technology general controls, an automated application control is expected to perform as designed)
- The degree of intervention by entity personnel contributing to the deviation (for example, was the deviation evidence of a possible override)
- Management's actions in response to the matter (if management was aware of the deviation)

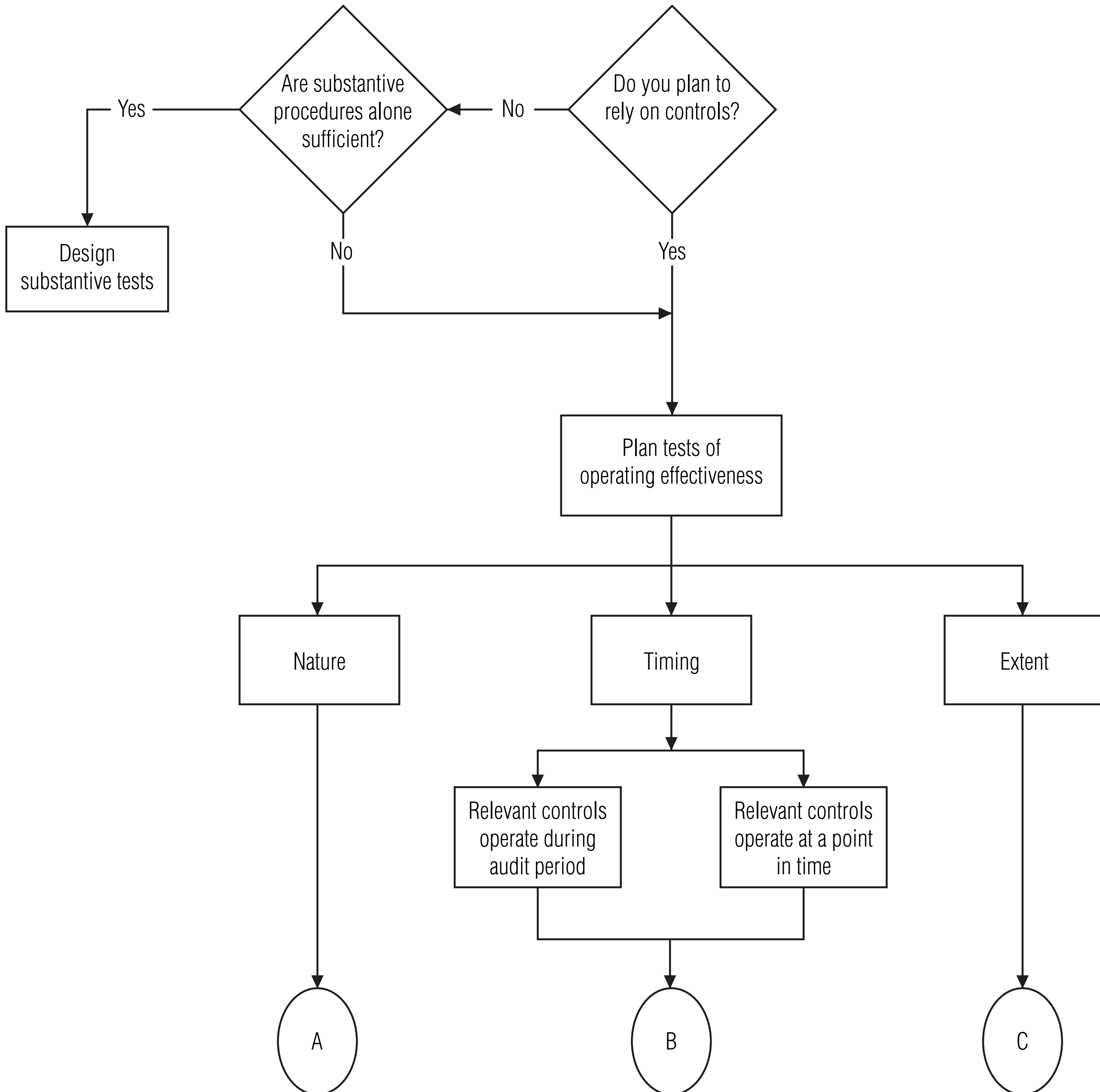
.57 Regardless of the reason for the deviation, numerous or repeated instances of the deviation may constitute a significant deficiency or material weakness.

.58 The following are examples of circumstances that may be deficiencies in internal control of some magnitude:

- Failure in the operation of properly designed controls within a significant account or process, for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
- Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy (for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements).
- Failure of controls designed to safeguard assets from loss, damage, or misappropriation. For example, a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. However, a preventive control failure may be mitigated by an effective detective control that prevents the misstatement of the financial statements. Suppose the inventory security control fails. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement to the financial statements if performed effectively and timely (near or at the reporting date). In the absence of a timely count, a deficient preventive control may be a deficiency in internal control of some magnitude.
- Failure to perform reconciliations of significant accounts, for example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
- Undue bias or lack of objectivity by those responsible for accounting decisions, for example, consistent under accruals of expenses or overstatement of allowances at the direction of management.
- Misrepresentation by client personnel to the auditor (an indicator of fraud).
- Management override of controls that would enable the entity to prepare financial statements in accordance with generally accepted accounting principles.
- Failure of an application control caused by a deficiency in the design or operation of an IT general control.

- An observed deviation rate that exceeds the number of deviations that the auditor expected in a test of the operating effectiveness of a control. For example, if the auditor designed a test in which he or she selected a sample and expected no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

.59 The following diagram summarizes the auditor's considerations related to tests of controls:



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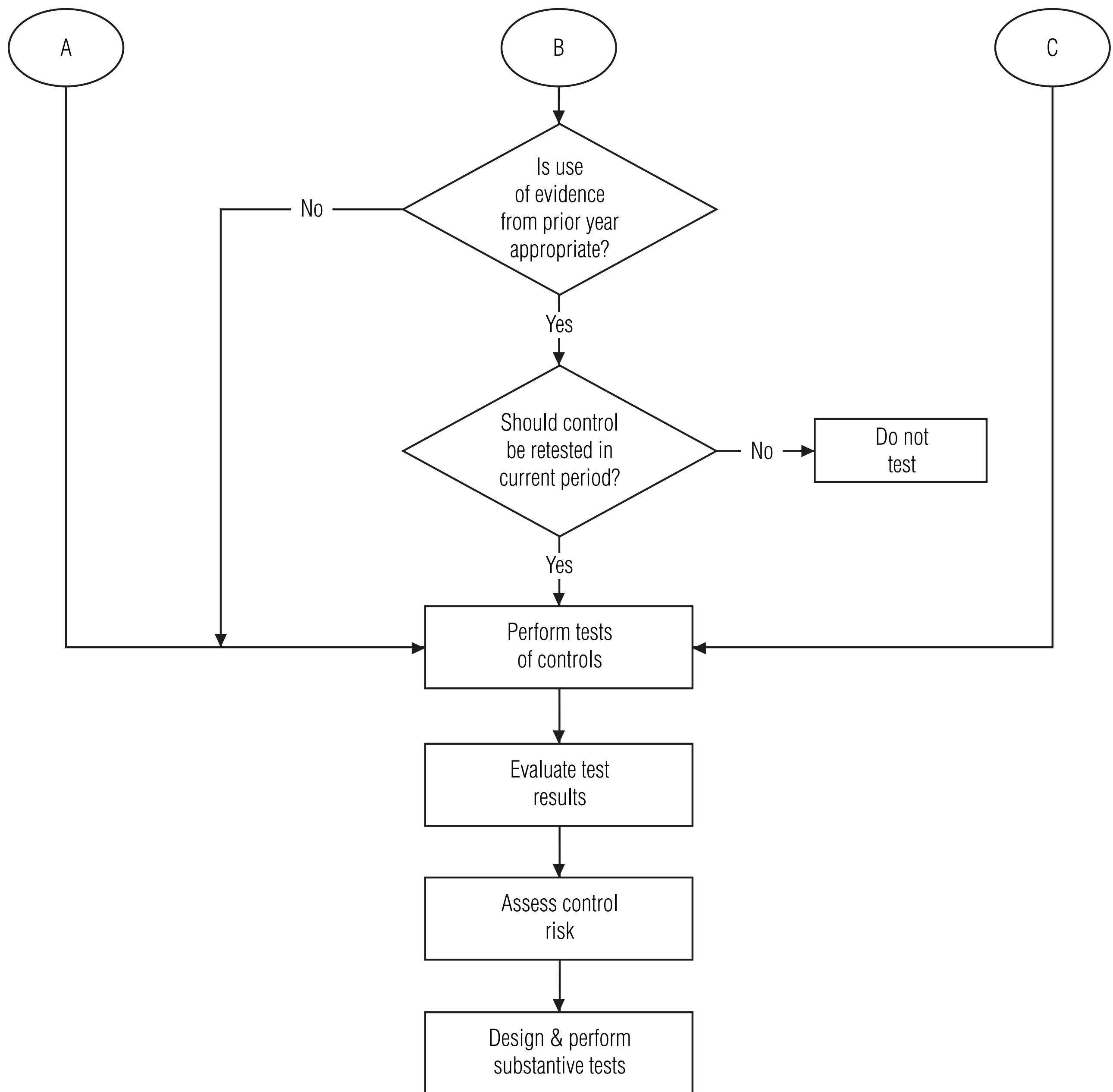
A
B
C
Is use of evidence from prior year appropriate?
No
Yes
Should control be retested in current period?
No
Do not test
Yes
Perform tests of controls
Evaluate test results
Assess control risk
Design & perform substantive tests

Documentation

.60 In regards to the performance of further audit procedures, the auditor should document the following:

- The overall responses to address the assessed risks of misstatement at the financial statement level
- The nature, timing, and extent of the further audit procedures
- The linkage of those procedures with the assessed risks at the relevant assertion level
- The results of the audit procedures
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit

The manner in which these matters are documented is based on the auditor's professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

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AAM Section 5300

Performing Substantive Procedures

.01 The objective of substantive procedures is to detect individual misstatements that alone or in the aggregate cause material misstatements at the assertion level. Substantive procedures include the following:

- Tests of details of transactions, account balances, and disclosures.
- Analytical procedures. AU section 329, *Analytical Procedures* (AICPA, *Professional Standards*), establishes standards and provides guidance on the application of analytical procedures as substantive tests.

.02 The auditor should plan and perform substantive procedures to be responsive to the related assessed risks of material misstatement. However, the auditor should perform certain tests regardless of the risk assessment because the risk assessment may not identify all risks.

- *Substantive tests of material items*. The auditor should perform substantive procedures for all relevant assertions for each material class of transactions, account balance, and disclosure. For example, if the auditor determines that long term debt is a material account, the auditor should perform substantive tests for all assertions that are relevant to long term debt, even if the auditor has determined that it is unlikely that the assertion could contain a material misstatement. The auditor may determine that the risk of the entity not having the obligation to repay the debt (the obligation assertion) is low, but nevertheless, the auditor should perform a substantive procedure (for example, confirming the terms of the debt with the lender) to address the risk. Because the account is material, the auditor is precluded from relying solely on risk assessment procedures or tests of controls to support the conclusion.
- *Substantive tests related to the financial statement reporting system*. On all engagements the auditor should
  - — agree the financial statements, including their accompanying notes, to the underlying accounting records and
  - — examine material journal entries and other adjustments made during the course of preparing the financial statements. The nature and extent of the auditor's examination of journal entries and other adjustments depend on the nature and complexity of the client's financial reporting system and the associated risks of material misstatement.

.03 When, in accordance with paragraph .110 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), the auditor has determined that an assessed risk of material misstatement at the relevant assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk. When the audit approach to significant risks consists only of substantive procedures, the audit procedures appropriate to address such significant risks consist of

- tests of details only.
- a combination of tests of details and analytical procedures.

That is, to address significant risks, it is unlikely that audit evidence obtained solely from substantive analytical procedures will be sufficient.

Nature of Substantive Procedures

.04 Substantive procedures include tests of details and substantive analytical procedures. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. Tests of details are ordinarily more appropriate to obtain audit evidence regarding certain relevant assertions about account balances, including existence and valuation.

.05 The auditor should plan substantive procedures to be responsive to the planned level of detection risk. In some situations, the auditor may determine that performing only substantive analytical procedures may be sufficient to reduce the planned level of detection risk to an acceptably low level. For example, the auditor may determine that performing only substantive analytical procedures is responsive to the planned level of detection risk for an individual class of transactions where the auditor's assessment of risk has been reduced by obtaining audit evidence from performance of tests of the operating effectiveness of controls. In other situations, the auditor may determine that tests of details only are appropriate, or that a combination of substantive analytical procedures and tests of details is most responsive to the assessed risks. The auditor's determination as to the substantive procedures that are most responsive to the planned level of detection risk is affected by whether the auditor has obtained audit evidence about the operating effectiveness of controls.

Tests of Details

.06 The auditor should design tests of details responsive to the assessed risk with the objective of obtaining sufficient appropriate audit evidence to achieve the planned level of assurance at the relevant assertion level. In designing substantive procedures related to the existence or occurrence assertion, the auditor should select from items contained in a financial statement amount and should obtain the relevant audit evidence. On the other hand, in designing audit procedures related to the completeness assertion, the auditor should select from audit evidence indicating that an item should be included in the relevant financial statement amount and should investigate whether that item is so included. The knowledge gained when understanding the business and its environment should be helpful in selecting the nature, timing, and extent of audit procedures related to the completeness assertion. For example, the auditor might inspect subsequent cash disbursements and compare them with the recorded accounts payable to determine whether any purchases had been omitted from accounts payable.

Substantive Analytical Procedures

.07 In designing substantive analytical procedures, the auditor should consider such matters as the following:

- The suitability of using substantive analytical procedures, given the assertions. Analytical procedures may not be suitable for all assertions. For example, transactions subject to management discretion (such as a decision to delay advertising expenses) may lack the predictability between periods or financial statement accounts that is necessary to perform and effective analytical procedure.
- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed. To assess the reliability of the data used in a substantive analytical procedure, the auditor may consider its source and the conditions under which it was gathered.
- Whether the expectation is sufficiently precise to identify the possibility of a material misstatement at the desired level of assurance. The precision of the auditor's expectation depends on (among other things)
    - — the identification and consideration of factors that significantly affect the amount being audited (for example, contributions to an employee 401(k) plan depends on compensation expense and the percentage of the employer contribution committed to by management).
    - — the level of data used to develop the expectation. Typically, expectations developed at a detailed level have a greater chance of detecting a material misstatement than do broad comparisons.

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- The amount of any difference in recorded amounts from expected values that is acceptable. The smaller the difference between the expected amount and the recorded amount that can be accepted, the more precise the expectation will typically be.
- The risk of management override of controls. Management override of controls might result in adjustments to the financial statements outside of the normal financial reporting process, which may result in artificial changes to the financial statement relationships being analyzed. These artificial relationships may result in the auditor drawing erroneous conclusions about the substantive analytical procedures.

Paragraphs .57–.67 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), direct the auditor to perform certain procedures to assess the risk of management override of controls.

.08 Paragraphs .09–.21 of AU section 329 establishes standards and provides additional guidance on the design of substantive analytical procedures.

Timing of Substantive Procedures

Substantive Procedures Performed at an Interim Date

.09 In some circumstances, the auditor may choose to perform substantive procedures at an interim date. When the auditor performs procedures as of a date in advance of year end, the risk that the auditor will fail to detect a material misstatement that may exist at year end is increased. This risk increases as the length of the period between interim tests and year end increases. The following table summarizes factors that may be considered when determining whether to perform substantive procedures at an interim date.

Matters to Consider in Determining Whether to Perform Substantive Procedures at an Interim Date

	Likelihood of Performing Substantive Procedures at an Interim Date	
Factor to consider	*More likely*	*Less likely*
Control environment and other relevant controls	Effectively designed or operating controls, including the control environment	Ineffectively designed or operating controls, including the control environment
The availability of information for the remaining period	Information is available that will allow the auditor to perform procedures related to the remaining period	Lack of information necessary to perform procedures related to the remaining period
Assessed risk	Lower risk of material misstatement for the relevant assertion	Higher risk of material misstatement for the relevant assertion
Nature of transactions or account balances and relevant assertions	Year-end balances are reasonably predictable with respect to amount, relative significance, and composition	Year-end balances can fluctuate significantly from interim balances, for example, due to rapidly changing business conditions, seasonality of business, or transactions that are subject to management's discretion
Ability to perform audit procedures to cover remaining period	The auditor will be able to perform all necessary procedures to cover the remaining period	The auditor's ability to perform procedures relating to the remaining period is limited, for example, by a lack of available information

.10 The objective of some of the tests may make the results of the tests irrelevant if performed at an interim date. For example, tests related to the preparation of the financial statements or the client's compliance with debt covenants typically provide relevant audit evidence only if performed at the period end.

.11 In addition to those items described in the preceding table, the circumstances of the engagement may result in the performance of certain tests at an interim date. For example, a client may request that the auditor identify all material misstatements a short period of time after year end (which is common for companies that plan to issue a press release of their earnings for the period). In that situation, the auditor may decide to confirm receivables prior to year end because the time period between the end of the period and the release of earnings is too short to allow the auditor to send and receive confirmations of customers and to complete the test work.

.12 The auditor's ability to perform audit procedures relating to the remaining period depends a great deal on whether the client's accounting system is able to provide the information needed for the auditor to perform his or her procedures. The auditor should consider whether that information is sufficient to permit investigation of the following:

- Significant unusual transactions or entries (including those at or near the period end)
- Other causes of significant fluctuations or fluctuations that did not occur
- Changes in the composition of the classes of transactions or account balances

.13 The timing of audit procedures also involves consideration of whether related audit procedures are coordinated properly. This consideration includes, for example, the following:

- Coordinating the audit procedures applied to related party transactions and balances
- Coordinating the testing of interrelated accounts and accounting cutoffs
- Maintaining temporary audit control over assets that are readily negotiable and simultaneously testing such assets and cash on hand and in banks, bank loans, and other related items

.14 When performing substantive procedures at an interim date, the auditor should perform substantive procedures or substantive procedures combined with tests of controls to cover the remaining period that provide a reasonable basis for extending audit conclusions from the interim date to the period end.

.15 When performing substantive procedures at an interim date, the auditor may reconcile the account balance at the interim date to the balance in the same account at year end. The reconciliation will allow the auditor to

- identify amounts that appear unusual,
- investigate these amounts, and
- define the appropriate population to perform substantive analytical procedures or tests of details to test the remaining period.

.16 If misstatements are detected in classes of transactions or account balances at an interim date, the auditor should consider modifying the related assessment of risk and the planned nature, timing, or extent of the substantive procedures covering the remaining period that relate to such classes of transactions or account balances, or the auditor may extend or may repeat such audit procedures at the period end.

Substantive Procedures Performed in Previous Audits

.17 In most cases, audit evidence from substantive procedures performed in a prior audit provides little or no audit evidence for the current period. To use audit evidence obtained during a prior period in the current period audit, both the audit evidence and the related subject matter must not fundamentally change. For example, a legal opinion would continue to be relevant audit evidence if it were received in a prior period related to the structure of a securitization transaction and no changes have occurred during the current period.

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If the auditor plans to use audit evidence from a prior period in the current audit, the auditor should perform audit procedures during the current period to establish the continuing relevance of the audit evidence.

Extent of the Performance of Substantive Procedures

.18 The greater the risks of material misstatement, the greater the extent of the auditor's substantive procedures. However, the nature of the audit procedures is of most importance in responding to assessed risks. Increasing the extent of an audit procedure is appropriate only if the procedure itself is relevant to the specified risk.

.19 *Considerations for designing tests of details.* When determining the extent of the tests of details, the auditor ordinarily thinks in terms of sample size. However, the auditor also may consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population, rather than performing sampling or stratifying the population into homogeneous subpopulations for sampling. AU section 350, *Audit Sampling* (AICPA, *Professional Standards*), and the AICPA Audit Guide *Audit Sampling*, provide guidance on the use of sampling and other means of selecting items for testing.

Adequacy of Presentation and Disclosure

.20 The auditor should perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, are in accordance with generally accepted accounting principles (GAAP). The auditor should consider whether the individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information. The presentation of financial statements in conformity with GAAP also includes adequate disclosure of material matters. These matters relate to the form, arrangement, and content of the financial statements and their related notes, including, for example, the terminology used, the amount of detail given, the classification of items in the financial statements, and the bases of amounts set forth. The auditor should consider whether management should have disclosed a particular matter in light of the circumstances and facts of which the auditor is aware at the time. In performing the evaluation of the overall presentation of the financial statements, including the related disclosures, the auditor should consider the assessed risk of material misstatement at the relevant assertion level. See paragraph .15 of AU section 326, *Audit Evidence* (AICPA, *Professional Standards*), for a description of the relevant assertions related to presentation and disclosure.

Documentation

.21 In regards to the performance of further audit procedures, the auditor should document the following:

- The overall responses to address the assessed risks of misstatement at the financial statement level
- The nature, timing, and extent of the further audit procedures
- The linkage of those procedures with the assessed risks at the relevant assertion level
- The results of the audit procedures
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit

The manner in which these matters are documented is based on the auditor's professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), establishes standards and provides guidance regarding documentation in the context of the audit of financial statements.

[*The next page is 5401.*]

AAM Section 5400

Audit Sampling Considerations

.01 Once an auditor decides what audit procedures to apply (the nature of the tests) and when to apply them (the timing of the tests), the next decision to be made is to determine how many items to apply which procedures to—that is, the extent of testing. The greater the risks of material misstatement, the less detection risk that can be accepted, and, consequently, the greater the extent of substantive procedures. Because the risks of material misstatement include consideration of the effectiveness of internal control, the extent of substantive procedures may be reduced by satisfactory results from tests of the operating effectiveness of controls. However, increasing the extent of an audit procedure is appropriate only if the audit procedure itself is relevant to the specific risk.

.02 In designing tests of details, the extent of testing is ordinarily thought of in terms of the sample size, which is affected by the planned level of detection risk, tolerable misstatement, expected misstatement, and nature of the population. However, the auditor should also consider other matters, including whether it is more effective to use other selective means of testing, such as selecting large or unusual items from a population as opposed to performing sampling or stratifying the population into homogeneous subpopulations for sampling.

Authoritative Standards

.03 AU section 350, *Audit Sampling* (AICPA, *Professional Standards*), addresses a variety of issues relating to the auditor's use of sampling in an audit engagement. However, AU section 350 does not always apply when the auditor is examining less than 100 percent of a population. The AICPA Audit Guide *Audit Sampling* presents recommendations on the application of generally accepted auditing standards to audits involving the use of audit sampling methods, and provides guidance to help auditors apply audit sampling in accordance with AU section 350.

When AU Section 350 Applies

.04 Audit sampling is only one of many tools used by auditors to obtain sufficient, appropriate audit evidence to support an opinion on financial statements. AU section 350 discusses design, selection, and evaluation considerations to be applied by the auditor when using audit sampling. As a general rule, audit sampling can be used

- in tests of controls in internal control to evaluate operating effectiveness from prescribed controls,
- in substantive tests of details of account balances and classes of transactions, and
- in dual purpose tests that assess control risk and test whether the monetary amount of a transaction is correct.

.05 The portion of AU section 350 pertaining to tests of controls applies when sampling techniques are used to assess control risk. The portion pertaining to substantive tests apply when sampling techniques are used to test details of transactions or balances.

.06 According to AU section 350, sampling occurs when the auditor tests less than 100 percent of a population for the purpose of evaluating some characteristic of an account balance or class of transactions. AU section 350 applies to tests of controls when such tests are performed and to tests of balances when sampling populations are material. The extent to which sampling is used in an audit depends on the size of the client and the nature of the client's internal control. Also, if the sampling populations are small, it could be more efficient to audit individually significant items and obtain audit assurance about the remaining

balance through analytical procedures than to perform audit sampling. As the size and sophistication of the client's internal control increases, the auditor is more likely to use audit sampling to perform tests of controls and tests of balances.

.07 In determining whether AU section 350 is applicable to circumstances in which an auditor examines less than 100 percent of the items making up an account balance or class of transactions, the auditor should consider the purpose of the test. AU section 350 establishes standards and provides guidance when 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. For example, if the auditor intends to examine selected sales invoices to draw a conclusion about whether sales are overstated, audit sampling as described in AU section 350 is 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 assess the accuracy and valuation of the remaining invoices, the auditor is not sampling according to AU section 350—the examination of the large items is not intended to lead the auditor to a conclusion about the other items. In that case, any conclusion about whether sales are overstated is based on the results of the test of large sales invoices, inquiry and observations, analytical procedures, and other auditing procedures performed on the smaller items related to overstatement of sales. However, in practice, it is difficult to attain high assurance regarding a significant aggregate amount of smaller items in the population from procedures other than sampling, such as analytical tests.

.08 The way in which the population is defined can determine whether the requirements of AU section 350 apply. The auditor might choose to divide a single reporting line on the financial statements into several populations. For example, accounts receivable might be divided into wholesale receivables, retail receivables, and employee receivables. Each of these populations can be tested using a different audit strategy—some using audit sampling and others not. The sampling concepts in AU section 350 apply only to populations for which audit sampling is used. Use of audit sampling on one population does not mandate its use on remaining populations.

Authoritative Guidance About the Application of Audit Sampling to Substantive Tests Provided by AU Section 350

.09 AU section 350 contains the following provisions regarding sampling in connection with substantive testing:

- The concept that some items exist which, in the auditor's judgment, acceptance of some sampling risk is not justified, and therefore should be examined 100 percent (see paragraph .21 of AU section 350). 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.
- The suggestion that the efficiency of a sample may be improved by separating items subject to sampling into relatively homogeneous groups based on some characteristic (see paragraph .22 of AU section 350). 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.
- Paragraph .18 of AU section 350 establishes a requirement that the auditor considers tolerable misstatement in planning audit sampling applications in the examination of account balances and classes of transactions. The auditor should 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. According to AU section 350, the auditor should consider tolerable misstatement and to recognize that it is one of the factors influencing sample size.
- Paragraph .24 of AU section 350 establishes a requirement that the auditor selects a sample that can be expected to be representative of the population. 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

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being selected. This does not mean that the auditor should use a random or probability sample, but that he or she should use a method that avoids bias (for example, selecting only simple transactions for testing).

- Paragraph .25 of AU section 350 establishes a requirement that the auditor considers selected sample items to which the auditor is unable to apply planned audit procedures to determine their effect on the evaluation of the sample. For example, sometimes the auditor may not be able to apply planned audit procedures to selected sample items because the entity may not be able to locate supporting documentation. If the auditor's evaluation of the sample results would not be altered by considering those unexamined items to be misstated, it is not necessary to examine the items. However, if considering those unexamined items to be misstated would lead to a conclusion that the balance or class contains material misstatement, the auditor should consider alternative audit procedures that would provide sufficient appropriate audit evidence to form a conclusion.
- Paragraph .26 of AU section 350 establishes a requirement that the auditor projects the misstatement results of the sample to the items from which the sample was selected. Because 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. The auditor should measure the likely misstatement in the population from which the sample was drawn and to consider it in reaching his or her conclusions.
- Paragraph .30 of AU section 350 establishes a requirement that the auditor considers, in the aggregate, projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications, along with other relevant audit evidence, when evaluating whether the financial statements taken as a whole may be materially misstated.

Documentation Requirements

.10 AU section 350 contains no specific documentation requirements. However, the documentation standards set forth in the Statements on Auditing Standards dealing with documentation apply to audit sampling applications just as they apply to other auditing procedures. AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), states that the auditor must develop an audit plan in which the auditor documents the audit procedures, and AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), states that audit documentation of tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include an identification of the items tested. The identification of the items tested may be satisfied by indicating the source from which the items were selected and the specific selection criteria, for example:

- when a haphazard or random sample is selected, the documentation should include identifying characteristics (for example, the specific invoice numbers of the items included in the sample);
- when all items over a specified dollar amount are selected from a listing, the documentation need describe only the scope and the identification of the listing (for example, all invoices over $25,000 from the December sales journal); and
- when a systematic sample is selected from a population of documents, the documentation need only provide an identification of the source of the documents and an indication of the starting point and the sampling interval (for example, a systematic sample of shipping reports was selected from the shipping log for the period from X to Y, starting with report number 14564 and selecting every 250th report from that point).

With regard to audit sampling applications, the audit program might document such items as the objectives of the sampling application and the audit procedures related to those objectives. Examples of items that the auditor may document for tests of controls are discussed in paragraph .25 of this section. Examples of items that the auditor typically documents for substantive tests are discussed in paragraph .55 of this section.

Determining Extent of Testing Without Sampling in a Small Business Audit[1]

.11 Small businesses have certain characteristics that may influence the auditor's decision to use audit sampling.

.12 For substantive testing, small businesses frequently have small populations of accounting data in both account balances and classes of transactions. Consequently, sampling may not be necessary when the necessary audit assurance is attained by examining a significant portion or aggregate value of all the transactions.

.13 Paragraph .01 of AU section 350 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. This definition allows some alternative approaches to sampling to determine the extent of testing in a small business engagement. These alternatives, by not using audit sampling and thus eliminating the requirements of AU section 350, may provide a more effective and efficient audit approach for a small business engagement.

.14 These alternative approaches include the following:

- Procedures applied to 100 percent of a certain group (strata) of transactions or balances
- Testing unusual items without applying procedures to the remainder of the population
- Other tests that involve application of procedures to less than 100 percent of the items in the population without drawing a conclusion about the entire account or class of transactions

.15 The auditor should decide what audit procedures to perform to meet the established audit objectives. Once this decision is made, the auditor needs to determine the extent of testing.

.16 An effective and efficient approach to determining the extent of testing in a small business engagement is shown in flowchart 1. This approach involves four important steps.

Identification of Individual Items to Be Examined

.17 The auditor is required to 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 the size of the item, whether the item is unusual, prior experience with the client, and whether the item involves a related party.

.18 For example, consider the following information for accounts receivable of a small business.

Number of Accounts	*Balances*	*Total Accounts*
4	$100,000 or more	$ 625,000
7	$25,000–99,999	375,000
62	$1–24,999	300,000
73		$1,300,000

In this case, if the 11 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). Provided the remaining $300,000 is not greater than tolerable misstatement or can be tested through other audit procedures, it may not be necessary to design a sample of the remaining items. 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).

[1] The concepts discussed in this section can also be applied to certain less complex account balances and classes of transactions in more complex entities.

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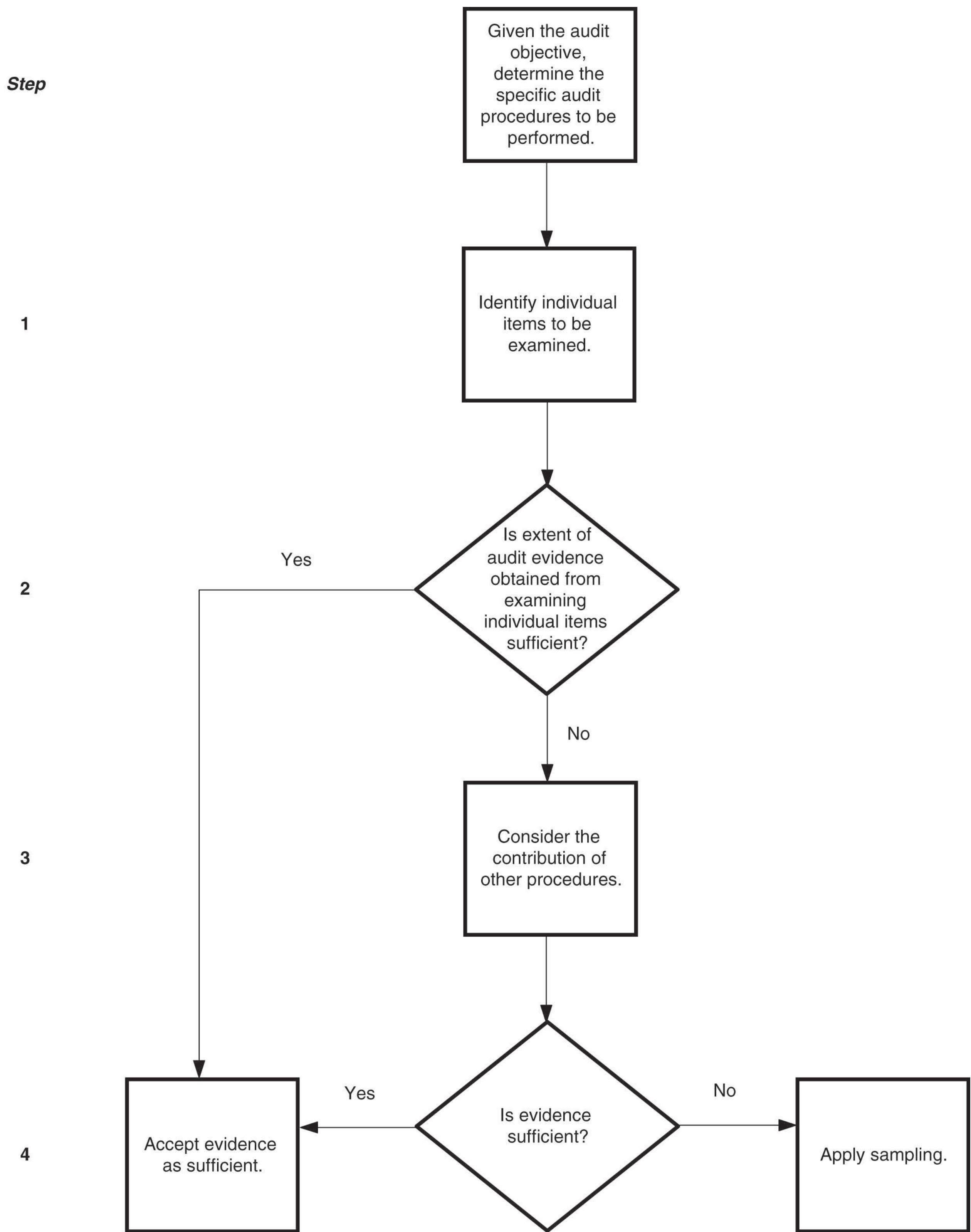
Flowchart 1
A Small Business Audit Sampling Approach



Is Extent of Audit Evidence Obtained Sufficient?

.19 The following are some factors in evaluating the sufficiency of audit evidence obtained in tests of details for a particular account balance or class of transactions:

- 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.
- The nature and cause of misstatements. If during the course of the audit, misstatements are discovered, those misstatements should be evaluated to determine if they are due to differences in principle or in application, are errors or fraud or are due to misunderstanding of instructions or carelessness.
- Possible relationship of the misstatement to other phases of the audit. If it is determined that the misstatement is due to fraud, this would ordinarily require a broader consideration of the possible implications than would the discovery of an error.
- The characteristics of the sample to the population. The auditor may obtain some knowledge of the types of items in the population if the characteristics in the sample are similar in nature and the same controls are followed for processing the transactions.

Consider Contribution of Other Procedures

.20 The auditor may also consider whether other evidence obtained contributes to conclusions regarding the account balance or class of transactions. The auditor often considers the contribution of other procedures at the same time the extent of audit evidence obtained from examining individual items is considered.

.21 The auditor may use a combination of analytical procedures and substantive tests of details to support an opinion on the financial statements. In deciding whether other audit procedures make a contribution, the auditor may 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 four 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 individually or in combination with other untested amounts be material to the financial statements. If the remaining population is less than material, the auditor may decide that no additional sampling is necessary, but may consider whether other procedures can provide sufficient assurance that any misstatement of the remaining population is not significant. Second, the auditor should consider the degree of risk involved (that is, how susceptible the account is to misstatement, and whether there have been problems with this area in prior audits). Third, the auditor should consider the sufficiency of all the audit evidence obtained so far (the extent of audit evidence obtained by testing individual items along with the contribution of other procedures). The final factor is the qualitative aspects of the misstatement. These include (*a*) the nature and cause of misstatements, such as whether there are differences in principle or in application, are errors or are caused by fraud, or are due to misunderstanding of instructions or to carelessness, and (*b*) the possible relationship of the misstatements to other phases of the audit. The discovery of fraud ordinarily requires a broader consideration of possible implications than does the discovery of an error.

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Audit Sampling for Tests of Controls

.25 AU section 350 indicates that an auditor may use nonstatistical or statistical sampling in performing tests of controls. This section provides guidance for both approaches. Regardless of whether nonstatistical or statistical sampling is being used, audit sampling for tests of controls involves the following steps:

- *Determine the objective of the test*. The objective of tests of controls is to provide evidence about the operating effectiveness of controls. Audit sampling for tests of controls is generally appropriate when application of the control leaves documentary evidence of performance. Normally, audit sampling for tests of controls will involve selecting a sample of documents and examining them for evidence that the relevant controls were applied. Tests of controls involving observation of performance of procedures or inquiries of the client are not normally subject to audit sampling. As with any test, it should be related to a relevant assertion.
- *Define the deviation conditions*. A deviation condition is a situation that indicates that the controls were not performed. For example, if the auditor is examining purchase invoices for evidence of approval of an expenditure (for example, the initials of the approving individual), a deviation condition would be an invoice that is not initialed by the appropriate individual. Performance of a control consists of all the steps the auditor believes are necessary to support the assessed level of control risk. For example, assume that a prescribed control requires that support for every disbursement should include an invoice, a voucher, a receiving report, and a purchase order, all stamped "Paid." The auditor believes that the existence of an invoice and a receiving report, both stamped "Paid," is necessary to indicate adequate performance of the control for purposes of supporting the assessed level of control risk. Therefore, a deviation may be defined as "a disbursement not supported by an invoice and a receiving report that have been stamped 'Paid.'"
- *Define the population*. The population selected should be appropriate for the objective being tested. For example, if the auditor is testing the operating effectiveness of a prescribed control designed to ensure that all shipments were billed, the auditor would not detect deviations by sampling from billed items. An appropriate population for detecting such deviations usually includes the record of all items shipped.
- *Define the period covered by the test*. For samples to be representative of the period under audit, the population generally includes all transactions processed during the period. Often, auditors perform tests of controls during interim work. The auditor should determine what additional evidence needs to be obtained for the remaining period. Often, the auditor obtains the additional evidence by extending the test to the transactions occurring in the remaining period. However, it is not always efficient to include all transactions executed throughout the period under audit in the population to be sampled. In some cases, it might be more efficient to use alternative approaches to test the performance of the control during the remaining period. In these cases the auditor would define the population to include transactions for the period from the beginning of the year to an interim date and consider the following factors in determining what, if any, additional evidence needs to be obtained for the remaining period:
    - The significance of the assertion involved
    - The specific controls that were tested during the interim period
    - Any changes in controls from the interim period
    - The extent to which substantive tests were changed as a result of the controls
    - The results of the tests of controls performed during the interim period
    - The length of the remaining period
    - The audit evidence about design or operation of controls or substantive correctness of the balances or transactions in the interim period that may result from the substantive tests performed in the remaining period
    - The relevance and effectiveness of information technology general controls

The auditor selects sampling units from a physical representation of the population. For example, if the auditor defines the population as all customer receivable balances as of a specific date, the physical representation might be a printout of the customer accounts receivable trial balance as of that date. Making selections from a controlled source minimizes differences between the physical representation and the population. The auditor should consider whether the physical representation includes the entire population. If the auditor reconciles the selected physical representation and the population and determines that the physical representation has omitted items in the population that should be included in the overall evaluation, the auditor should select a new physical representation or perform alternative procedures on the items excluded from the physical representation.

- *Define the sampling unit*. The sampling unit is defined in light of the control being tested. A sampling unit may be, for example, a document, an entry, or a line item, where examination of the sampling unit provides evidence of the operation of the control. An important efficiency consideration in selecting a sampling unit is the manner in which documents are filed and cross-referenced.
- *Determine the method of selecting the sample*. Any sample that is selected should be representative of the population (selected in an unbiased manner) and all items should have an opportunity to be selected. Random number selection is generally used when statistical sampling is being applied. When nonstatistical sampling is applied, random number sampling, systematic sampling, haphazard sampling, and block sampling are methods that might be used to obtain a representative sample. Methods of selecting samples are discussed beginning at paragraph .60 of this section.
- *Determine the sample size*. Sample sizes for tests of controls are affected by (*a*) the risk of assessing control risk too low, (*b*) the tolerable rate, (*c*) the expected population deviation rate, and (*d*) any effects of small population sizes.
- Guidance for determining sample size when performing nonstatistical sampling begins with paragraph .28 of this section. A description of statistical sampling begins with paragraph .31 of this section.
- *Perform the sampling plan*. Once the sample has been selected, the auditor should examine the selected items to determine whether they contain deviations from the prescribed control. If the auditor selects a voided item, and the auditor obtains reasonable assurance that the item has been properly voided and does not represent a deviation from the prescribed control, he or she should replace the voided item. If the auditor selects an unused item, he or she should obtain reasonable assurance that it actually represents an unused item, not a deviation from the control, and then replace the unused item. If the auditor is unable to examine a selected item because it cannot be located or for any other reason, and the auditor is unable to apply the planned audit procedures or appropriate alternative procedures to selected items, he or she should consider the selected items to be deviations from the controls for purposes of evaluating the sample. In addition, the auditor should consider the reasons for this limitation and the effect that such a limitation might have on his or her understanding of internal control and assessment of control risk.
- *Evaluate the sample results*. Guidance for evaluating nonstatistical sampling results begins with paragraph .30 of this section and guidance for evaluating statistical sampling results begins with paragraph .32 of this section.
- *Document the sampling procedure*. Examples of items that the auditor typically documents for tests of controls include the following:
  - A description of the control being tested. The control objectives related to the sampling application, including the relevant assertions.
  - The definition of the population (the source from which the items were selected) and the sampling unit, including how the auditor considered the completeness of the population.
  - The definition of the deviation condition.

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- The acceptable risk of overreliance on controls (or desired confidence or assurance level), the tolerable deviation rate, and the expected population deviation rate used in the application.[2]
- The method of sample-size determination.
- The method of sample selection.
- The selected sample items.
- A description of how the sampling procedure was performed.
- The evaluation of the sample and the overall conclusion.

.26 *Factors Affecting Sample Sizes for Tests of Controls.* Sample sizes for tests of controls are affected by the following factors:

- *Acceptable risk of assessing control risk too low*. The risk of assessing control risk too low is the risk that the assessed level of control risk based on the sample is less than the true operating effectiveness of the control. Decreasing the risk of assessing control risk too low will increase the sample size.
- *Expected population deviation rate.* The expected population deviation rate is an anticipation of the deviation rate in the entire population. As the expected population deviation rate increases, the sample size will increase.
- *Tolerable rate.* Tolerable rate is the maximum rate (percentage) of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk. Higher tolerable rates will permit smaller sample sizes.
- *Population size.* The size of the population has little or no effect on the determination of sample size except for very small populations. For example, it is generally appropriate to treat any population of more than 2,000 sampling units as if it were infinite. If the population size is under 2,000 sampling units, the population size may have a small effect on the calculation of the sample size.

.27 The effects of these factors on the appropriate nonstatistical sample size may be summarized as follows:

Factor	*General Effect on Sample Size*
Risk of assessing control risk too low— increase (decrease)	Smaller (larger)
Tolerable rate—increase (decrease)	Smaller (larger)
Expected population deviation rate— increase (decrease)	Larger (smaller)
Population size	Virtually no effect

.28 *Sample Sizes Using Nonstatistical Sampling.* The auditor using nonstatistical sampling for tests of controls uses his or her professional judgment to consider the factors described in paragraph .26 of this section in determining sample sizes.

.29 Paragraph .23 of AU section 350 states that to determine the number of items to be selected in a sample for a particular test of details, the auditor should consider the tolerable misstatement and the expected misstatement, the audit risk, the characteristics of the population, the assessed risks of material misstatement (inherent risk and control risk), and the assessed risk for other substantive procedures related to the same assertion. An auditor who applies statistical sampling uses tables or formulas to compute sample size based on these judgments. An auditor who applies nonstatistical sampling uses professional judgment to relate these factors in determining the appropriate sample size. Ordinarily, this would result in a sample size comparable

[2] In some instances, sample size inputs such as acceptable risk of overreliance, tolerable deviation rate, and expected deviation rate are built into firm-wide sample size tables. In these instances, reference to firm sample size guidance is sufficient (that is, each team does not need to document inputs that are implicit in the firm's sample size tables).

to the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters.[3] It is important to note, however, that auditors are not required to specifically compute a statistical sample size. Nevertheless, auditors might find it helpful to be familiar with the tables in paragraphs .33–.36 of this section. Auditors using these tables as an aid in understanding relative sample sizes for tests of controls will need to apply professional judgment in reviewing the risk levels and expected population deviation rates in relation to sample sizes. Also, an auditor may decide to establish guidelines for sample sizes for tests of controls based on attribute sampling tables.

.30 After completing the examination of the sampling units and summarizing deviations from prescribed controls, the auditor evaluates the results.

- *Calculate the deviation rate*. Calculating the deviation rate in the sample involves dividing the number of observed deviations by the sample size.
- *Consider sampling risk*. When evaluating a sample for a test of controls, consideration may be given to sampling risk.
- *Consider the qualitative aspects of deviations*. In addition to evaluating the frequency of deviations from pertinent controls, the auditor should consider the qualitative aspects of the deviations.
- *Reach an overall conclusion*. The auditor uses professional judgment to reach an overall conclusion about the effect that the evaluation of the results will have on the assessed level of control risk and on the nature, timing and extent of planned substantive tests.

.31 *Sample Sizes Using Statistical Sampling*. The appropriate statistical method for tests of controls is *attributes sampling*, which is a technique designed to estimate qualitative characteristics of a population. Attributes sampling is most commonly used in auditing to test the rate of deviation from a prescribed control to support the auditor's assessed level of control risk.

.32 Applying attributes sampling involves performing the following steps:

a. *Decide on the attributes to test*. The tests of controls may include the testing of one or more attributes. Proper evaluation of the results may require testing and evaluating each attribute separately.

b. *Define the population from which the sample items should be selected*. The auditor should make sure that the population is appropriate for the audit objective as described in paragraph .25 of this section.

c. Specify the following factors:

i. *Acceptable risk of assessing control risk too low*. There is an inverse relationship between the risk of assessing control risk too low and sample size. If the auditor is willing to accept only a low risk of assessing control risk too low, the sample size would ordinarily be larger than if a higher risk were acceptable. When auditors seek high assurance from important controls, the risk is often set at 10 percent or less.

ii. *Tolerable rate*. Higher assessments of control risk will permit higher tolerable deviation rates. When auditors seek high assurance from important controls, the tolerable deviation rates are generally set at 10 percent or less.

iii. *Expected population deviation rate*. The auditor's expectations may be based on prior year's tests and the control environment. The prior year's results may be considered in light of changes in the entity's internal control and changes in personnel. Sample sizes will increase significantly as the expected population deviation rate increases from zero. If the deviation rate in the sample turns out to be higher than the rate specified by the auditor in determining the sample size, the sample results will not support the auditor's planned assessed level of control risk.

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[3] This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory.

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d. Determine the appropriate sample size. Example sample sizes are found in the tables in paragraphs .33–.34 of this section. The table in paragraph .33 is designed for a risk of assessing control risk too low of 5 percent, and the table in paragraph .34 is designed for a 10 percent risk of assessing control risk too low. With the tolerable rate and the expected population deviation rate, the auditor may find the sample size from the table. The numbers in parentheses are the number of deviations that may be found in the sample and still support the auditor's planned assessed level of control risk.

e. Randomly select the sample from the population. The section beginning at paragraph .60 of this section describes the methods that may be used to select a random sample.

f. Perform the audit procedures to identify deviations in the sample.

g. Calculate the statistical results. Using the tables in paragraphs .35–.36 of this section or the appropriate risk of assessing control risk too low, determine the actual tolerable deviation rate from the sample size and the actual number of deviations found in the sample.

h. Reassess the level of control risk. If the sample results, along with other relevant evidential matter, support the planned assessed level of control risk, the auditor generally does not need to modify planned substantive tests. If the planned assessed level of control risk is not supported, the auditor would ordinarily either perform tests of other controls that could support the planned assessed level of control risk or increase the assessed level of control risk.

i. Document the Sampling Procedures. AU section 350 and the AICPA Audit Guide *Audit Sampling* do not require specific documentation of audit sampling applications. See paragraph .10 of this section for certain documentation requirements of AU section 339. Examples of items that the auditor typically documents for tests of controls are discussed in paragraph .25 of this section. Auditors may also refer to the Audit Guide *Audit Sampling* for more information.

.33

Statistical Sample Sizes for Test of Controls—5 Percent Risk of Overreliance (With Number of Expected Errors in Parentheses)

Expected Deviation Rate	Tolerable Deviation Rate										
	2%	**3%**	**4%**	**5%**	**6%**	**7%**	**8%**	**9%**	**10%**	**15%**	**20%**
0.00%	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)	29(0)	19(0)	14(0)
0.25%	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.50%	313(2)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
0.75%	386(3)	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.00%	590(6)	257(3)	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.25%	1,030(13)	303(4)	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.50%		392(6)	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)	46(1)	30(1)	22(1)
1.75%		562(10)	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)	46(1)	30(1)	22(1)
2.00%		846(17)	294(6)	181(4)	127(3)	88(2)	77(2)	68(2)	46(1)	30(1)	22(1)
2.25%		1,466(33)	390(9)	208(5)	127(3)	88(2)	77(2)	68(2)	61(2)	30(1)	22(1)
2.50%			513(13)	234(6)	150(4)	109(3)	77(2)	68(2)	61(2)	30(1)	22(1)
2.75%			722(20)	286(8)	173(5)	109(3)	95(3)	68(2)	61(2)	30(1)	22(1)
3.00%			1,098(33)	361(11)	195(6)	129(4)	95(3)	84(3)	61(2)	30(1)	22(1)
3.25%			1,936(63)	458(15)	238(8)	148(5)	112(4)	84(3)	61(2)	30(1)	22(1)
3.50%				624(22)	280(10)	167(6)	112(4)	84(3)	76(3)	40(2)	22(1)
3.75%				877(33)	341(13)	185(7)	129(5)	100(4)	76(3)	40(2)	22(1)
4.00%				1,348(54)	421(17)	221(9)	146(6)	100(4)	89(4)	40(2)	22(1)
5.00%					1,580(79)	478(24)	240(12)	158(8)	116(6)	40(2)	30(2)
6.00%						1,832(110)	532(32)	266(16)	179(11)	50(3)	30(2)
7.00%								585(41)	298(21)	68(5)	37(3)
8.00%									649(52)	85(7)	37(3)
9.00%										110(10)	44(4)
10.00%										150(15)	50(5)
12.50%										576(72)	88(11)
15.00%											193(29)
17.50%											720(126)

Note: Sample sizes over 2,000 items not shown. This table assumes a large population.

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Statistical Sample Sizes for Test of Controls—10 Percent Risk of Overreliance (With Number of Expected Errors in Parentheses)

Expected Deviation Rate	Tolerable Deviation Rate										
	2%	3%	4%	5%	6%	7%	8%	9%	10%	15%	20%
0.00%	114(0)	76(0)	57(0)	45(0)	38(0)	32(0)	28(0)	25(0)	22(0)	15(0)	11(0)
0.25%	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
0.50%	194(1)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
0.75%	265(2)	129(1)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.00%	398(4)	176(2)	96(1)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.25%	708(9)	221(3)	132(2)	77(1)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.50%	1,463(22)	265(4)	132(2)	105(2)	64(1)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
1.75%		390(7)	166(3)	105(2)	88(2)	55(1)	48(1)	42(1)	38(1)	25(1)	18(1)
2.00%		590(12)	198(4)	132(3)	88(2)	75(2)	48(1)	42(1)	38(1)	25(1)	18(1)
2.25%		974(22)	262(6)	132(3)	88(2)	75(2)	65(2)	42(1)	38(1)	25(1)	18(1)
2.50%			353(9)	158(4)	110(3)	75(2)	65(2)	58(2)	38(1)	25(1)	18(1)
2.75%			471(13)	209(6)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.00%			730(22)	258(8)	132(4)	94(3)	65(2)	58(2)	52(2)	25(1)	18(1)
3.25%			1,258(41)	306(10)	153(5)	113(4)	82(3)	58(2)	52(2)	25(1)	18(1)
3.50%				400(14)	194(7)	113(4)	82(3)	73(3)	52(2)	25(1)	18(1)
3.75%				583(22)	235(9)	131(5)	98(4)	73(3)	52(2)	25(1)	18(1)
4.00%				873(35)	274(11)	149(6)	98(4)	73(3)	65(3)	25(1)	18(1)
5.00%					1,019(51)	318(16)	160(8)	115(6)	78(4)	34(2)	18(1)
6.00%						1,150(69)	349(21)	182(11)	116(7)	43(3)	25(2)
7.00%							1,300(91)	385(27)	199(14)	52(4)	25(2)
8.00%								1,437(115)	424 34)	60(5)	25(2)
9.00%									1,577(142)	77(7)	32(3)
10.00%										100(10)	38(4)
12.50%										368(46)	63(8)
15.00%											126(19)
17.50%											457(80)

Note: Sample sizes over 2,000 items not shown. This table assumes a large population.

.35

Statistical Sampling Results Evaluation Table for Tests of Controls— Upper Limits at 5 Percent Risk of Overreliance

Sample Size	Actual Number of Deviations Found 0	1	2	3	4	5	6	7	8	9	10
20	14.0	21.7	28.3	34.4	40.2	45.6	50.8	55.9	60.7	65.4	69.9
25	11.3	17.7	23.2	28.2	33.0	37.6	42.0	46.3	50.4	54.4	58.4
30	9.6	14.9	19.6	23.9	28.0	31.9	35.8	39.4	43.0	46.6	50.0
35	8.3	12.9	17.0	20.7	24.3	27.8	31.1	34.4	37.5	40.6	43.7
40	7.3	11.4	15.0	18.3	21.5	24.6	27.5	30.4	33.3	36.0	38.8
45	6.5	10.2	13.4	16.4	19.2	22.0	24.7	27.3	29.8	32.4	34.8
50	5.9	9.2	12.1	14.8	17.4	19.9	22.4	24.7	27.1	29.4	31.6
55	5.4	8.4	11.1	13.5	15.9	18.2	20.5	22.6	24.8	26.9	28.9
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	20.8	22.8	24.8	26.7
65	4.6	7.1	9.4	11.5	13.6	15.5	17.5	19.3	21.2	23.0	24.7
70	4.2	6.6	8.8	10.8	12.7	14.5	16.3	18.0	19.7	21.4	23.1
75	4.0	6.2	8.2	10.1	11.8	13.6	15.2	16.9	18.5	20.1	21.6
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9	17.4	18.9	20.3
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2	15.5	16.9	18.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8	14.0	15.2	16.4
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3	11.3	12.3	13.2
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6	9.5	10.3	11.1
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5	7.2	7.8	8.4
300	1.0	1.6	2.1	2.6	3.1	3.5	4.0	4.4	4.8	5.2	5.6
400	0.8	1.2	1.6	2.0	2.3	2.7	3.0	3.3	3.6	3.9	4.3
500	0.6	1.0	1.3	1.6	1.9	2.1	2.4	2.7	2.9	3.2	3.4

Note: This table presents upper limits (body of table) as percentages. This table assumes a large population.

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Statistical Sampling Results Evaluation Table for Tests of Controls— Upper Limits at 10 Percent Risk of Overreliance

Sample Size	Actual Number of Deviations Found										
	0	1	2	3	4	5	6	7	8	9	10
20	10.9	18.1	24.5	30.5	36.1	41.5	46.8	51.9	56.8	61.6	66.2
25	8.8	14.7	20.0	24.9	29.5	34.0	38.4	42.6	46.8	50.8	54.8
30	7.4	12.4	16.8	21.0	24.9	28.8	32.5	36.2	39.7	43.2	46.7
35	6.4	10.7	14.5	18.2	21.6	24.9	28.2	31.4	34.5	37.6	40.6
40	5.6	9.4	12.8	16.0	19.0	22.0	24.9	27.7	30.5	33.2	35.9
45	5.0	8.4	11.4	14.3	17.0	19.7	22.3	24.8	27.3	29.8	32.2
50	4.6	7.6	10.3	12.9	15.4	17.8	20.2	22.5	24.7	27.0	29.2
55	4.2	6.9	9.4	11.8	14.1	16.3	18.4	20.5	22.6	24.6	26.7
60	3.8	6.4	8.7	10.8	12.9	15.0	16.9	18.9	20.8	22.7	24.6
65	3.5	5.9	8.0	10.0	12.0	13.9	15.7	17.5	19.3	21.0	22.8
70	3.3	5.5	7.5	9.3	11.1	12.9	14.6	16.3	18.0	19.6	21.2
75	3.1	5.1	7.0	8.7	10.4	12.1	13.7	15.2	16.8	18.3	19.8
80	2.9	4.8	6.6	8.2	9.8	11.3	12.8	14.3	15.8	17.2	18.7
90	2.6	4.3	5.9	7.3	8.7	10.1	11.5	12.8	14.1	15.4	16.7
100	2.3	3.9	5.3	6.6	7.9	9.1	10.3	11.5	12.7	13.9	15.0
125	1.9	3.1	4.3	5.3	6.3	7.3	8.3	9.3	10.2	11.2	12.1
150	1.6	2.6	3.6	4.4	5.3	6.1	7.0	7.8	8.6	9.4	10.1
200	1.2	2.0	2.7	3.4	4.0	4.6	5.3	5.9	6.5	7.1	7.6
300	0.8	1.3	1.8	2.3	2.7	3.1	3.5	3.9	4.3	4.7	5.1
400	0.6	1.0	1.4	1.7	2.0	2.4	2.7	3.0	3.3	3.6	3.9
500	0.5	0.8	1.1	1.4	1.6	1.9	2.1	2.4	2.6	2.9	3.1

Note: This table presents upper limits (body of table) as percentages. This table assumes a large population.

Audit Sampling for Substantive Tests of Details

.37 The purpose of substantive tests of details of transactions and balances is to detect material misstatements in the account balance, transaction class, and disclosure components of the financial statements. An auditor assesses the risks of material misstatement and relies on a combination of further control tests, analytical procedures, and substantive tests of details for providing a basis for the opinion about whether the financial statements are materially misstated. When testing the details of an account balance or class of transactions, the auditor might use audit sampling to obtain evidence about the reasonableness of monetary amounts.

.38 The auditor uses professional judgment to determine whether audit sampling is appropriate. Sampling may not always be appropriate. For example, the auditor may decide that it is more efficient to test an account balance or class of transactions by applying analytical procedures.

.39 When an auditor plans any audit sampling application, the first consideration is the specific account balance or class of transactions and the circumstances in which the procedure is to be applied. The auditor generally identifies items or groups of items that are of individual significance to an audit objective and relevant assertion. For example, an auditor planning to use audit sampling as part of the tests of an inventory balance as well as observing the physical inventory would generally identify items that have significantly large balances or that might have other special characteristics.

.40 The auditor considers all special knowledge about the items constituting the balance or class before designing audit sampling procedures. For example, the auditor might identify 20 items that make up 25 percent of the account balance, and decide that those items should be examined 100 percent and excluded from inventory subject to audit sampling. Any items that the auditor has decided to test 100 percent are not part of the population subject to sampling.

.41 A population for audit sampling purposes does not necessarily need to be an entire account balance or class of transactions. In some circumstances, an auditor might examine all the items that constitute an account balance or class of transactions that exceed a given amount or that have an unusual characteristic; the auditor might either (*a*) apply other auditing procedures (for example, analytical procedures) to items that do not exceed a given amount or possess an unusual characteristic or (*b*) apply no auditing procedures to them because there are acceptably low risks of material misstatement existing in the remaining items.

.42 Once a decision has been made to use audit sampling, the auditor may choose between statistical and nonstatistical sampling. The choice is primarily a cost-benefit consideration. Statistical sampling uses the laws of probability to measure sampling risk. Any sampling procedure that does not measure the sampling risk is a nonstatistical sampling procedure.

.43 *Determining the test objectives*. A sampling plan for substantive tests of details might be designed to (*a*) test the reasonableness of one or more assertions about a financial statement amount (for example, the existence of accounts receivable) or (*b*) make an independent estimate of some amount (for example, the last in, first out [LIFO] index for a LIFO inventory). The auditor should carefully identify the characteristic of interest (for example, the misstatement) for the sampling application that is consistent with the audit objective.

.44 *Defining the population*. The population consists of the items constituting the account balance or class of transactions of interest. The auditor should determine that the population from which he or she selects the sample is appropriate for the specific audit objective because sample results can be projected only to the population from which the sample was selected.

.45 *Defining the sampling unit*. A sampling unit is any of the individual elements that constitute the population, and depends on the audit objective and the nature of the audit procedures to be applied. A

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sampling unit might be a customer account balance, an individual transaction or an individual entry in a transaction. The auditor might consider which sampling unit leads to a more effective and efficient sampling application in the circumstances.

.46 *Choosing an audit sampling technique*. Either statistical or nonstatistical sampling is appropriate for substantive tests of details. The most common statistical approaches are classical variables sampling and monetary unit sampling.

.47 *Determining the method of selecting the sample*. The auditor should select the sample in such a way that the sample can be expected to be representative of the population or the stratum from which it is selected.

.48 *Determining the sample size*. Accounting populations tend to include a few very large amounts, a number of moderately large amounts, and a large number of small amounts. Auditors consider the variation in a characteristic when they determine an appropriate sample size for a substantive test, and, generally, the variation of the items' recorded amounts as a means of estimating the variation of the audited amounts of the items in the population. A measure of this variation, or scatter, is called the standard deviation. Sample sizes generally decrease as the variation becomes smaller. Sample sizes from unstratified populations with high variation are generally much larger than stratified samples from the same population.

.49 In performing substantive tests of details, auditors are also concerned with two aspects of sampling risk:

a. *Risk of incorrect acceptance*—the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.

b. *Risk of incorrect rejection*—the risk that the sample supports the conclusion that the recorded amount is materially misstated when it is not. This risk is generally controlled by setting an adequate or conservative estimate of expected misstatement and increasing the sample size accordingly.

.50 When planning a sample for a substantive test of details, the auditor should consider how much monetary misstatement in the related account balance or class of transactions is acceptable without causing the financial statements to be materially misstated. The maximum monetary misstatement for the balance or class is called tolerable misstatement for the sample. For a particular account balance or class of transactions, the sample size required to achieve the auditor's objective at a given risk of incorrect acceptance increases as the auditor's assessment of tolerable misstatement for that balance or class decreases.

.51 The auditor also assesses the expected amount of misstatement on the basis of his or her professional judgment after considering such factors as the entity's business, the results of prior year's tests of account balances or class of transactions, the results of any pilot sample, the results of any related substantive tests, and the results of any tests of the related controls.

.52 The effect of population size on the appropriate sample size varies according to the audit sampling method used.

.53 *Performing the sampling plan*. The auditor should apply auditing procedures appropriate for the particular audit objectives to each sample item.

.54 *Evaluating the sample results*. In evaluating sample results, the auditor should do the following:

- Project the misstatements found in the sample to the population from which the sample was selected and add that amount to the misstatements discovered in any items examined 100 percent.
- Propose known misstatements to management for correction, unless the amounts are trivial.
- Compare the tolerable misstatement for the account balance or class of transactions with the total projected misstatement, adjusted for any corrected misstatements. If the total projected misstatement is less than tolerable misstatement for the account balance or class of transactions, the auditor should consider the risk that such a result might be obtained even though the true monetary misstatement

for the population exceeds the tolerable misstatement. In accordance with paragraph .30 of AU section 350, projected misstatement results for all audit sampling applications and all known misstatements from nonsampling applications should be considered in the aggregate along with other relevant audit evidence when the auditor evaluates whether the financial statements taken as a whole may be materially misstated.

- Consider the qualitative aspects of misstatements. If the sample results suggest that the auditor's planning assumptions were in error, appropriate action is taken.

.55 *Documenting the sampling procedure*. AU section 350 and the AICPA Audit Guide *Audit Sampling* do not require specific documentation of audit sampling applications. See paragraph .10 of this section for certain documentation requirements of AU section 339. Examples of items that the auditor may document for substantive tests include the following:

- The objectives of the test the accounts and assertions affected
- The definition of the population and the sampling unit, including how the auditor determined the completeness of the population
- The definition of a misstatement
- The risk of incorrect acceptance or level of desired assurance (confidence)
- The risk of incorrect rejection, if used
- Estimated and tolerable misstatement
- The audit sampling technique used
- The method used to determine sample size
- The method of sample selection
- Identification of the items selected
- A description of the performance of the sampling procedures and a list of misstatements identified in the sample
- The evaluation of the sample (for example, projection and consideration of sampling risk)
- A summary of the overall conclusion (if not evident from the results)
- Any qualitative factors considered significant in making the sampling assessments and judgments

.56 *Nonstatistical sampling for substantive tests of details*. Paragraph .23 of AU section 350 states that to determine the number of items to be selected in a sample for a particular test of details, the auditor should consider the tolerable misstatement and the expected misstatement, the audit risk, the characteristics of the population, the assessed risks of material misstatement (inherent risk and control risk), and the assessed risk for other substantive procedures related to the same assertion. An auditor who applies statistical sampling uses tables or formulas to compute sample size based on these judgments. An auditor who applies nonstatistical sampling uses professional judgment to relate these factors in determining the appropriate sample size. Ordinarily, this would result in a sample size comparable to the sample size resulting from an efficient and effectively designed statistical sample, considering the same sampling parameters.[4] It is important to note, however, that auditors are not required to specifically compute a statistical sample size. Nevertheless, auditors might find familiarity with sample sizes based on statistical theory helpful when applying professional judgment and experience in considering the effect of various planning considerations on sample size.

.57 The following table, "Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning," summarizes the effects of various factors on sample sizes for substantive tests of details. (The table

[4] This guidance does not suggest that the auditor using nonstatistical sampling compute a corresponding sample size using statistical theory.

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is provided only to illustrate the relative effect of different planning considerations on sample size and is not intended as a substitute for professional judgment).

Factors Influencing Sample Sizes for a Substantive Test of Details in Sample Planning

	Conditions Leading to:		
Factors	*Smaller Sample Size*	*Larger Sample Size*	*Related Factor for Substantive Sample Planning*
a. Assessment of inherent risk	Low assessed level of inherent risk	High assessed level of inherent risk	Allowable risk of incorrect acceptance
b. Assessment of control risk	Low assessed level of control risk	High assessed level of control risk	Allowable risk of incorrect acceptance
c. Assessment of risk related to other substantive procedures directed at the same assertion (including substantive analytical procedures and other relevant substantive procedures)	Low assessment of risk associated with other relevant substantive procedures	High assessment of risk associated other relevant substantive procedures	Allowable risk of incorrect acceptance
d. Measure of tolerable misstatement for a specific account	Larger measure of tolerable misstatement	Smaller measure of tolerable misstatement	Tolerable misstatement
e. Expected size and frequency of misstatements, or the estimated variance of the population	Smaller misstatements or lower frequency, or smaller population variance	Larger misstatements, higher frequency, or larger population variance	Assessment of population characteristics
f. Number of items in the population	Virtually no effect on sample size unless population is very small		

.58 For additional details on audit sampling, including detailed tables, auditors may refer to AICPA Audit Guide *Audit Sampling* and the appendix of AU section 350.

.59 Stratification is particularly important to increasing the efficiency of the sample. If the nonstatistical sample design is planned without stratification, the auditor should increase the sample size. Before selecting the sample, the auditor generally identifies individually significant items and may then select the sample from the remaining items using the systematic selection method, which automatically stratifies the sample, or stratify the remaining items into groups and allocate the sample size accordingly.

.60 *Evaluating the sample results*. The misstatement in the sample should be projected to the items from which the sample was selected. One method of projecting the amount of misstatement found in a sample is to divide the amount of misstatement in the sample by the fraction of total dollars in the population included in the sample. For example, if a $100 misstatement is found in a sample of 10 percent of the population, the projected misstatement would be $1,000 ($100 ÷ .10).

.61 A second method for projecting the misstatement uses the average difference between the audited and the recorded amounts of each item included in the sample. For example, if $200 of misstatement is found in a sample of 100 items, the average difference between audited and recorded amounts for items in the sample is $2 ($200 ÷ 100). An estimate of the amount of misstatement in the population may be calculated by multiplying the total number of items in the population (in this case 5,000 items) by the average difference of $2 for each sample item. The estimate of misstatement in the population is $10,000 (5,000 × 2).

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AAM Section 5500

Suggested Supplemental Reference Materials

.01 The following publications are useful in helping to determine the nature, timing, and extent of audit procedures. To order AICPA products, call 888.777.7077.

- **Audit and Accounting Guides (AICPA)**

  Each guide describes relevant matters, conditions, and procedures unique to a particular industry, and illustrates treatments of financial statements and reports to caution auditors and accountants about unusual problems.

- **Audit Risk Alerts (AICPA)**

  Audit Risk Alerts complement the guidance provided in many of the Audit and Accounting Guides by describing current economic, regulatory, and professional developments that can have a significant impact on engagements.

- **Financial Reporting Alerts (AICPA)**

  Financial Reporting Alerts are useful for members of an entity's financial management, board members, and audit committee to identify and understand current accounting and regulatory developments affecting the entity's financial reporting.

- **Professional Standards (AICPA)**

  The publication features the outstanding pronouncements on professional standards issued by the AICPA, including standards for audits, compilations, and reviews.

- **Financial Statement Preparation Manual (AICPA)**

  This publication provides sample statements and checklists for a variety of business enterprises and governmental units.

- **Disclosure Checklist Series (AICPA)** (individual paperback versions of sections of the Financial Statement Preparation Manual)

  The practice aids are invaluable to anyone who prepares financial statements and reports. The material has been updated to reflect AICPA, Financial Accounting Standards Board, and Governmental Accounting Standards Board pronouncements and interpretations as well as Securities and Exchange Commission regulations.

- **Accounting Trends & Techniques (AICPA)**

  This publication contains reporting methods based on a cumulative survey, as well as significant accounting presentations, discussions, and trends of accounting principles generally accepted in the United States. By following the lead of these industry front-runners, practitioners can apply the latest techniques and improve their own reporting performance. Additional versions of this publication are also available for preparers of financial statements for not-for-profit entities and preparers of financial statements of international companies that are using International Financial Reporting Standards.

- **Fraud Detection in a GAAS Audit (Revised Edition) (AICPA)**

  This practice aid provides CPAs with the most recent information related to complying with AU section 316, Consideration of Fraud in a Financial Statement Audit *(AICPA,* Professional Standards*).*

- **Technical Practice Aids (AICPA)**

  This publication contains all outstanding AICPA Auditing and Attestation Statements of Position and Practice Alerts; Technical Questions and Answers issued by the AICPA on a variety of accounting, auditing, and industry topics; implementation guidance issued by the staff of the Public Company Accounting Oversight Board; and Trust

Services Principles, Criteria, and Illustrations; and offers carefully thought-out responses to selected inquiries received by the AICPA Technical Hotline and AICPA Technical and Industry Committees.

- **Standard Form to Confirm Account Balance Information with Financial Institutions (AICPA)**

This form may be used to request a full report on credit balance, liabilities, and contingent liabilities. It may also be used for a confirmation of bank balance only.

- **Accountants' Handbook by Carmichael, Lilien & Mellman (Wiley)**
- **Montgomery's Auditing by O'Reilly, Hirsch, Defliese, and Jaenicke (Wiley)**
- **Handbook of Modern Accounting by Davidson & Weil (McGraw-Hill)**
- **Kohler's Dictionary for Accountants by Coopers & Ijiri (Prentice-Hall)**

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AAM Section 6000
Audit Documentation

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AAM Section 6100

Audit Documentation—General

.01 Audit documentation is the record of audit procedures performed, relevant audit evidence obtained, and conclusions reached by the auditor in the engagement. Audit documentation, also known as *working papers*, may be recorded on paper or on electronic or other media. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), establishes standards and provides guidance on the form, general content, and ownership and confidentiality of audit documentation.

.02 Other Statements on Auditing Standards (SASs) contain specific documentation requirements and can be found in appendix A of AU section 339. Additionally, specific documentation or document retention requirements may be included in other standards (for example, government auditing standards), laws, and regulations applicable to the engagement.

.03 The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached. Audit documentation provides the principal support for the representation in the auditor's report that the auditor performed the audit in accordance with generally accepted auditing standards and provides the principal support for the opinion expressed regarding the financial information or the assertion to the effect that an opinion cannot be expressed.

.04 Among other matters, AU section 339 provides the following:

- The auditor should prepare audit documentation in connection with each engagement in sufficient detail to provide an experienced auditor with no previous connection to the audit a clear understanding of the work performed (including the nature, timing, extent and results of audit procedures performed), the audit evidence obtained and its source, and the conclusions reached.
- Oral explanations on their own do not represent sufficient support for the work the auditor performed or conclusions the auditor reached, but they may be used by the auditor to clarify or explain information contained in the audit documentation.
- The auditor should document significant findings or issues, actions taken to address them (including any additional evidence obtained), the basis for the final conclusions reached, and discussions of the significant findings or issues with management or others, including responses and when and with whom the discussion took place. If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusions regarding a significant finding or issue, the auditor should document how the auditor addressed the contradiction or inconsistency.
- The auditor should assemble the audit documentation to form the final audit engagement file on a timely basis but within 60 days following the report release date (also known as the *documentation completion date*). After this date, the auditor must not delete or discard audit documentation before the end of the specified retention period and should appropriately document any subsequent additions. (Paragraphs .23–.30 of AU section 339 establish standards and provide guidance regarding revisions to audit documentation after the date of the auditor's report.)

Audit Documentation Retention

.05 AU section 339 states that the auditor should adopt reasonable procedures to retain and access audit documentation for a period of time sufficient to meet the needs of his or her practice and to satisfy any applicable legal or regulatory requirements for records retention. Such retention period, however, should not

be shorter than 5 years from the report release date. Statutes, regulations, or the audit firm's quality control policies may specify a longer retention period.

.06 Determining the proper periods for retaining records is a major decision for practitioners. Records may be preserved for only as long as they serve a useful purpose or until all legal requirements are met. Record retention periods vary among firms; however, retention periods generally correspond with the longest statute of limitations prevailing in each state for breach of contract, breach of fiduciary duty, and professional liability claims.

.07 Audit documentation may be retained permanently or for periods corresponding with the longest state statute of limitations, as noted in the previous paragraph. Generally, certain audited financial statement working paper data, such as accounts receivable confirmations, are destroyed after 10 years. Examples of audit documentation that the auditor may wish to retain permanently include auditor's reports, reports filed with the Securities and Exchange Commission, tax returns for current clients, and audit documentation for current clients. Some firms divide the retention period into 2 parts, records are first filed in the office and later placed in storage (for example, 3 years in the office and then permanently in storage). Other records, such as audit documentation files for former clients, may be retained for 3 years in the office, 7 years in storage, and then destroyed after the retention period has ended. The auditor may obtain specific approval of the engagement partner before destroying any audit documentation. An annual schedule may be established for reviewing and purging firm data. Because there is substantial variation in the retention periods used by firms, each firm may carefully consider its requirements and consult with legal counsel before adopting a retention period.

.08 For further guidance on record retention, see the AICPA *Management of an Accounting Practice Handbook* (online subscription product no. MAP-XX) at www.cpa2biz.com. This product can also be obtained by calling the AICPA order department at 888.777.7077 and asking for product no. MAP-XX (online) or product no. 090407 (looseleaf).

Ownership and Confidentiality of Audit Documentation

.09 Audit documentation is the property of the auditor, and some states recognize this right of ownership in their statutes.

.10 The auditor has an ethical, and in some situations a legal, obligation to maintain the confidentiality of client information. Because audit documentation contains confidential client information, the auditor should adopt reasonable procedures to maintain the confidentiality of that information.

.11 Whether audit documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the auditor's knowledge or could be permanently lost or damaged. Accordingly, the auditor should apply appropriate and reasonable controls for audit documentation to

a. clearly determine when and by whom audit documentation was created, changed, or reviewed;

b. protect the integrity of the information at all stages of the audit, especially when the information is shared within the audit team or transmitted to other parties via electronic means;

c. prevent unauthorized changes to the documentation; and

d. allow access to the documentation by the audit team and other authorized parties as necessary to properly discharge their responsibilities.

Documentation of Departures From the SASs

.12 In rare circumstances when the auditor departs from a presumptively mandatory requirement in the SASs, he or she must document the justification for the departure and how the alternative procedures in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement.

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General Discussion

.13 These sections present points of view on the organization and preparation of audit documentation.

.14 Proper planning is important in the design of specific audit documentation if the documentation is to serve the objective of aiding the auditor in the conduct of his or her 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 form, content, and extent of audit documentation are matters of the auditor's professional judgment and depend on the circumstances of the engagement and the audit methodology and tools used. The individual preferences of auditors and firms may be informal common practices or expressed as part of a firm's formal policies and procedures. A firm may consider the nature of its practice and the services commonly provided to its clients, in addition to professional standards, in developing its procedures and policies on audit documentation. Those procedures and policies may permit the flexibility necessary to meet the needs of individual engagements.

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AAM Section 6200

Form, Content, and Extent of Audit Documentation

.01 The form, content, and extent of audit documentation vary with the circumstances and needs of the auditors on individual engagements. Some firms, however, include various general and specific instructions on audit documentation content in their policies concerning the working papers.

.02 Examples of audit documentation are audit programs, analyses, issues, memoranda, summaries of significant findings or issues, letters of confirmation and representation, checklists, abstracts or copies of important documents, correspondence (including e-mail), and schedules or commentaries prepared or obtained by the auditor. Abstracts or copies of the entity's records should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. Audit documentation may be in paper form, electronic form, or other media.

.03 The auditor should prepare audit documentation that enables an experienced auditor, having no previous connection to the audit, to understand

a. the nature, timing, and extent of auditing procedures performed to comply with Statements on Auditing Standards and applicable legal and regulatory requirements, including (i) who performed the audit work and the date such work was completed and (ii) who reviewed specific audit documentation and the date of such review;

b. the results of the audit procedures performed and the audit evidence obtained;

c. the conclusions reached on significant matters; and

d. that the accounting records agree or reconcile with the audited financial statements or other audited information.

.04 In determining the form, content, and extent of audit documentation, the auditor should consider the following factors:

- The nature of the auditing procedures to be performed
- The identified risks of material misstatement associated with the assertion or account or class of transactions, including related disclosures
- The extent of judgment involved in performing the work and evaluating the results
- The significance of the audit evidence obtained to the assertion being tested
- The nature and extent of exceptions identified
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or evidence obtained

Basic Elements of Format

.05 Audit documentation formats generally include at least the following for identification purposes:

- A title or heading including (*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

.06 In instances when audit documentation extends beyond 1 page, some auditors present the heading on only the lead page and 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 preestablished manner. This provides for ease in cross-referencing to other relevant papers, for more organized indexing and filing, and for a form of control over the audit documentation. (See section 6300, "Organization and Filing (Indexing).")

.07 Some auditors purchase standard analysis paper that includes preprinted blocks for the initials or signature of the preparer and reviewer and the dates on which the paper was prepared and reviewed. Others design their own signature and reference blocks and have them imprinted on all of their analysis paper and lined pads. These signature blocks may include captions such as the following:

- Prepared by client and tested by
- Prepared by
- Date prepared
- Date tested
- Reviewed by
- Date reviewed
- Source
- Audit documentation reference
- Footed by
- Extensions checked by

.08 Some auditors prefer to identify client preparation of schedules and analysis by notations or codes, such as PBC (prepared by client), rather than use a detailed signature and reference block.

General Considerations

.09 The following are some general considerations on audit documentation content that may be helpful:

- The auditor may include identification of the (*a*) source of the information presented (for example, fixed assets ledger or cash disbursements journal), (*b*) the nature and extent of the work done and conclusions reached (by symbols and legend, narrative, or a combination of both), and (*c*) appropriate cross-references to other working papers in the content of an individual working paper or group of related papers.
- The auditor should document significant findings or issues, actions taken to address them, and the basis for the final conclusions reached. If for some reason the auditor leaves the assignment before resolving all items, he or she may provide an open items listing on a separate temporary paper for the in-charge auditor's attention. An unresolved exception or incomplete explanation in the working papers may be construed by some as indication of an inadequate audit.
- Information and comments in the audit documentation generally represent statements of fact and professional conclusions. Accordingly, the auditor may wish to refrain from using vague judgmental adjectives such as *good* or *bad*. Conclusions should be supported by documented facts, especially if they concern the adequacy of the client's records.
- Working papers are an integrated presentation of information. The auditor may find it useful to cross-reference working papers to call attention to inter-account relationships and to reference a paper to other working papers summarizing or detailing related information.

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- All inferences and conclusions should be supported in the working papers, and no misleading or irrelevant statements should be made.
- It is preferable to have negative figures in audit documentation indicated by parentheses instead of red figures to preserve their identity if the papers are photocopied or scanned.

Specific Considerations

.10 As mentioned in the preceding section, abstracts or copies of the entity's records should be included as part of the audit documentation if they are needed to enable an experienced auditor to understand the work performed and conclusions reached. Additionally, audit documentation of procedures performed, including tests of operating effectiveness of controls and substantive tests of details that involve inspection of documents or confirmation should include the identifying characteristics of the specific items tested.

.11 Furthermore, the auditor should document significant findings or issues, actions taken to address them (including any additional evidence obtained), and the basis for the final conclusions reached. Significant audit findings or issues include, but are not limited to, the following:

- Significant matters involving the selection, application, and consistency of accounting principles with regard to the financial statements, including related disclosures. Such matters include, but are not limited to, (*a*) accounting for complex or unusual transactions or (*b*) accounting estimates and uncertainties and, if applicable, the related management assumptions.
- Results of auditing procedures that indicate (*a*) that the financial statements or disclosures could be materially misstated or (*b*) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
- Circumstances that cause significant difficulty in applying auditing procedures that the auditor considered necessary.
- Findings that could result in modification of the auditor's report.
- Audit adjustments. For purposes of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), an audit adjustment is a correction of a misstatement of the financial information that is identified by the auditor, whether or not recorded by management, that could, either individually or when aggregated with other misstatements, have a material effect on the company's financial information.

Timesaving Considerations

.12 There are a number of ways to save time and avoid unnecessary detail in audit documentation preparation. For example, the auditor may consider the following examples:

- 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 a detailed audit program that may eliminate the need for lengthy comments in the audit documentation on the scope of audit procedures. However, some believe that such comments are still necessary when a detailed program is used; this is a matter of individual firm judgment.
- Analyze asset (or liability) accounts and their related expense or income accounts on the same working paper. Examples include property, plant, and equipment, accumulated depreciation, and related depreciation expense; notes receivable, accrued or prepaid 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 the 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.
- Use symbols (tick marks) whenever possible, especially when the same symbol applies to several working papers.

Symbols (Tick Marks)

.13 When using symbols, it may be helpful to consider the following basic concepts:

- Symbols are merely a shorthand means of explaining a work step performed on a particular item of data. Symbols serve as means of conserving time and space and, if properly used, may ease review of the audit documentation.
- For a working paper to be clear to a reviewer or other reader, it is important that each symbol 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.
- Simple, distinctive, and clear symbols can be quickly written by the preparer and easily identified by a reviewer.

.14 Applying these basic concepts is not that simple. Various auditors have conflicting notions about symbols. For example, some believe a set of standardized symbols can expedite preparation and review. Others believe that a set of standardized symbols is impractical because it lacks flexibility. Because it is generally agreed that symbols are an effective timesaver, it is desirable for firms to establish and communicate a policy on their use to maximize their potential effectiveness.

.15 The most commonly used symbols 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. These combinations alone provide eight distinctive tick marks. Symbols may also include circled letters or numbers.

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AAM Section 6300

Organization and Filing (Indexing)

.01 Some auditors organize their audit documentation during the course of an engagement into general categories such as the following:

- Planning and administration
- Internal control understanding and assessment of control risk
- Substantive test audit documentation arranged in order of the balance sheet and income statement classifications
- Trial balances, consolidating working papers, journal entries (adjustments, reclassifications, eliminations for consolidation), and potential entries
- Draft reports, financial statements, and notes
- Programs, checklists, and questionnaires (some keep these as separate units, and 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 may be deferred until the conclusion of the engagement.

Predetermined Indexing

.02 Other practitioners and firms may use a predetermined indexing approach so that working papers can be indexed while the field work is still in progress. This offers the following advantages:

- Better control over audit documentation during the performance of field work
- Constant arrangement of audit documentation in logical order to aid in review
- Less time required in assembling and filing them into indexed files
- Quicker access to specific audit documentation after it is filed

.03 Predetermined indexing involves establishing a standard code for each section of the audit documentation using letters and numbers or numbers only. See the following table for an 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 and expense	P/L	T/B-3
Cash summary schedule	A	10
Receivables summary schedule	B	20
Inventory summary schedule	C	30

.04 Predetermined indexing requires recognition of the need for flexibility to meet unanticipated audit documentation needs or specialized industry requirements, and it requires care to avoid undue complexity.

Excessively complex references may obstruct rather than ease audit documentation preparation, cross-referencing, and filing. Accordingly, it is helpful to develop an organizational plan adaptable to each section of the audit documentation. For example, some accountants classify working papers as lead schedules, primary detail, and secondary detail that might result in the following classification scheme for the preceding examples for cash.

	Using Letters and Numbers	*Using Only Numbers*
Lead schedule	(A)	(10)
Primary detail schedules	(A-1) (A-2) and so forth	(10-1) (10-2) and so forth
Secondary detail schedules	(A-1-1) (A-1-2) (A-1-3)	(10-1-1) (10-1-2)
	(A-2-1) (A-2-2) (A-2-3)	(10-2-1) (10-2-2)

.05 Predetermined (standardized) indexing systems may be printed on separate pages for reference during the performance of field work and insertion in the front of audit documentation binders or files when the work is completed. Some firms have their uniform indexing systems printed directly on their file or binder covers.

.06 A well-organized indexing system need not be too complex. On a fairly small engagement, the indexing system may be a lead schedule divider tab between each major group of accounts with the name of the account on it (for example, cash or accounts receivable) with the related working papers filed behind the lead schedule without being individually indexed. At the completion of the engagement, the pages can be consecutively numbered within each account group (for example, 1 of 10, 2 of 10, and so forth). Because there typically are not numerous or complex layers of supporting schedules, extensive cross-referencing can be avoided.

.07 On large engagements, particularly those with detailed charts of accounts, firms may consider it necessary to develop more complex indexing systems. In one such system, standard index number series are assigned as follows:

Current audit documentation	1000–7000
Permanent file	7100–9999

.08 In this system, each index number has 4 digits, with the addition of 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, and so forth. Documentation, such as supporting confirmations and lists of outstanding checks, would be assigned index numbers commencing with 2001.1, 2001.2, and so forth. As for the permanent audit documentation file, index 9300, for example, may be assigned to internal control. Accordingly, flowcharts and related questionnaires would be assigned index numbers in that series.

Current and Permanent Files

.10 Audit documentation files are generally classified as current files and permanent (continuing) files. Current files contain information that is pertinent to a single engagement. Permanent files include information relevant to several recurring engagements. Some firms have their binder or file covers preprinted as current or permanent accompanied by pertinent portions of their uniform audit documentation indexes.

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.11 A common challenge to many auditors is to keep the permanent file complete, current, and free from outdated or irrelevant materials that belong in an inactive file of superseded materials.

.12 Some auditors who have confronted many unwieldy permanent files believe that it is better to classify all audit documentation 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 1 type of file or binder cover and provide space to indicate whether specific contents are continuing or carry forward in nature. Regardless of the approach used, it is important to recognize that the provisions of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), apply to current year audit documentation maintained in *any* type of file (this includes permanent files) if such documentation serves as support for the current year's audit report.

.13 The requirements and guidance in AU section 339 also apply to permanent files. Accordingly, permanent files should be reviewed and updated, as needed, in conjunction with the annual audit. Examples of documents that may be found in permanent files are listed in paragraph .07 of section 6100.

Practice Tip

The audit documentation files should contain copies of final executed documents when needed to enable an experienced auditor to understand the work performed and conclusions reached. Any drafts or unsigned versions of documents should be replaced with final versions.

Index Topics

.14 The following is a list of topics to consider in developing a standard index for audit documentation. This list is detailed, but it 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:

Planning and administration

- Time and budget data
- General correspondence and memos
- Memos—current
- Notes and copies for use in next engagement
- Engagement letters
- Schedules and analyses to be prepared by client
- Minutes
- Checklist of an administrative nature if required by firm policy

Audit or work program[1]

Matters of continuing concern

- Client's industry—background
- Description and brief history of client
- Data and ratio analysis of client's operations
- Client's facilities

[1] Alternate practices of filing audit programs include

a. putting the program in a binder that is separate and distinct from current and permanent files;

b. putting the signed-off program in the current file; and

c. keeping a master copy of the program in the permanent file with the signed off copies dispersed among the related audit documentation segments in the current file.

- Articles of incorporation
- Bylaws
- Current contracts and agreements
  - Debt agreements
  - Leases
  - Labor contracts
  - Agreements with officers and key people
  - Pension plans
  - Profit-sharing plans
  - Stock warrants
  - Stock options
  - Other agreements
  - Client's accounting policies and procedures
  - Carryforward analyses[2]

Internal control

- Internal control questionnaire, narrative, flowcharts, and so forth[3]
- Initial assessment of control risk memos
- Tests of controls

Reports, financial statements and footnotes, trial balances, and assembly sheets

- Reports and financial statements (including letters, if any, on reportable conditions in internal control)
- Consolidating working papers
- Consolidation eliminating entries
- Trial balance
- Adjusting journal entries
- Reclassification journal entries
- Recap of possible adjusting entries
- Assembly sheets supporting footnote disclosures (if the information is not included elsewhere in the audit documentation)
- Disclosure checklists (if required by firm policy)
- Supporting schedules (if required for reports to regulatory bodies or other reports)
- Tax return information and work sheets[4]

[2] Certain classifications may lend themselves to carry-forward audit documentation. Examples include allowances for doubtful accounts, brief summaries of confirmation response statistics, accumulated depreciation and amortization, deferred income taxes and open tax positions, long term debt, and capital accounts. Carry-forward audit documentation depends on the auditor's professional judgement and the nature of the specific account.

[3] Internal control questionnaires may be filed as separate binders or as part of current of permanent files.

[4] Some firms and practitioners keep tax return preparation working papers in files that are completely separate from other types of engagement working papers.

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Assets

- Cash
- Marketable securities (and related income)
- Notes receivable (and related interest)
- Accounts receivable
  - Summary and analyses
  - Confirmation procedures[5, 6]
- Allowance for doubtful accounts and notes[7]
- Inventories
  - Summary and analysis
  - Price tests, cost, and market
  - Obsolescence review
  - Observation, test counts, and cutoff data
  - Last in, first out determinations
- Prepaid expenses
- Other current assets
- Investments
- Property, plant and accumulated depreciation, and depletion and amortization[8]
- Intangible deferred charges and amortization[9]
- Other assets
- Intercompany accounts

Liabilities

- Notes payable (and related interest)
- Accounts payable
- Accrued liabilities other than income taxes
- Accrued income taxes (both current and deferred), related provisions, and credits[10]
  - Federal
  - State and local
- Other current liabilities
- Long-term debt (including current maturities and capitalized leases)[11]
- Other long-term liabilities

---

[5] See footnote 2.

[6] For situations involving voluminous responses or bulk inventory listings, the bulk materials may be filed in separate binders that are cross referenced to the pertinent audit documentation (for example, accounts receivable, accounts payable, and inventory).

[7] See footnote 2.

[8] See footnote 2.

[9] See footnote 2.

[10] See footnote 2.

[11] See footnote 2.

- Deferred income[12]

Commitments and contingencies

- Attorney's letters
- Abstractors of commitments and contingencies noted during review of minutes, contracts and agreements, confirmation responses, and so forth
- Subsequent events review
- Management representation letter

Equity (capital accounts)[13]

- Capital stock
- Additional paid-in capital
- Treasury stock
- Retained earnings
- Partnership capital

Revenue and expenses

- Operating revenues
- Cost of sales
- Selling, general and administrative
- Other operating expenses
- Other income
- Other expense
- Extraordinary and unusual items
- Secondary schedules
  - — Maintenance and repairs
  - — Taxes other than income taxes
  - — Rents
  - — Royalties
  - — Advertising costs
  - — Legal fees
  - — Interest expense recap

[*The next page is 7001.*]

[12] See footnote 2.
[13] See footnote 2.

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AAM Section 7000 Correspondence, Confirmations, and 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 profes sional 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 audit documentation, second requests, and manuscript copies for the next engagement.

.02 There are two types of confirmation requests: the positive form and the negative form. Some positive forms request the respondent to indicate whether he or she agrees with the information stated on the request. Other positive forms, referred to as blank forms, do not state the amount (or other information) on the confirmation request, but request the recipient to fill in the balance or furnish other information.

.03 The negative form requests the recipient to respond only 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 could 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 may then be stuffed in envelopes and submitted to the post office under the auditor's control.[1]

.06 The auditor should control the mailings and receipt of responses so that the confirmation process is independent of the client.

.07 The auditor may consider including the firm's office or post office box number as the return address on mailing envelopes 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 may be enclosed with the request letter. Reply envelopes generally have prepaid postage to encourage responses. Some auditors also use codes on the reply envelopes so that responses may be sorted by engagement before the mail is opened. This feature may be particularly useful when there are several engagements that involve voluminous mailings.

---

[1] Interpretation No. 1, "Use of Electronic Confirmations," of AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*, AU sec. 9330 par. .01–.08), states that properly controlled electronic confirmations may be considered to be reliable audit evidence and discusses auditor considerations when using electronic confirmations.

.09 If the client objects to use of the auditor's name and address, some auditors suggest that a post office box in the client's name be used, with the returns to be opened under the auditor's control for the confirmation process, and that the post office be instructed that after the box is closed subsequent mail be forwarded to the auditor.

[*The next page is 7201.*]

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AAM Section 7200

Requests for Confirmations and Related Materials

Wording of Confirmation Request Forms

.01 Forms and correspondence used for confirmation requests should state clearly that the client is requesting that a reply be sent to the CPA. Forms and correspondence used for information requests for engagements other than audits should not refer to "an audit." They should also use the term *accountant(s)* rather than *auditors*. Suggested wording follows:

> Please send the following information to our certified public accountants [*name and address of accountants*] who are performing accounting services for the company.

.02 The samples of correspondence in this section include language that refers to auditors and an audit of the client's financial statements on the assumption that an audit is being performed. This language needs to be modified if services other than an audit are being performed.

.03 Request for Bank Cutoff Statement

[*Prepared on Client's Letterhead*]

[*Date*]

Financial Institution Official
First United Bank
Anytown, USA 00000

In connection with an audit of the financial statements of [*name of client*] as of [*balance sheet date*] and for the [*period*] then ended, we request that you send the following information directly to our auditors [*name and address of auditors*] as of close of business [*balance sheet date*]:

1. The information requested on the enclosed standard form(s) to confirm account balance information with your financial institution.
2. For the following account numbers, statement(s) of our account(s) and the related paid checks for the period from [*balance sheet date*] to [*two weeks subsequent to the balance sheet date*] inclusive.

Account Number	*Account Name*
______________________	______________________
______________________	______________________
______________________	______________________

Sincerely,
[*Name of Customer*]

____

By:____________________

Notes:

(A) This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or who is knowledgeable about the transactions or arrangements. Some financial institutions centralize this function by assigning responsibility for responding to confirmation requests to a separate function. Independent auditors should ascertain the appropriate recipient.

(B) The request could be sent at least ten days prior to the audit date so the bank will be able to provide the information requested and to render the cutoff statements as requested. If the request does not reach the bank before the cutoff date, the cutoff statement will include transactions after that date.

(C) The letter may also include requests for the following:

- 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 in cluding titles and account numbers).
- Confirmation of the list of authorized signers for the listed accounts. (This may have been previously requested at a preliminary date in connection with assessment of control risk.)

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.04 Standard Form to Confirm Account Balance Information With Financial Institutions

STANDARD FORM TO CONFIRM ACCOUNT BALANCE INFORMATION WITH FINANCIAL INSTITUTIONS

____

CUSTOMER NAME

Financial Institution's Name and Address

[ ]

[ ]

We have provided to our accountants the following information as of the close of business on ________________, 20_____, regarding our deposit and loan balances. Please confirm the accuracy of the information, noting any exceptions to the information provided. If the balances have been left blank, please complete this form by furnishing the balance in the appropriate space below.* Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other deposit and loan accounts we may have with you comes to your attention, please include such information below. Please use the enclosed envelope to return the form directly to our accountants.

1. At the close of business on the date listed above, our records indicated the following deposit balance(s):

ACCOUNT NAME	ACCOUNT NO.	INTEREST RATE	BALANCE*

2. We were directly liable to the financial institution for loans at the close of business on the date listed above as follows:

ACCOUNT NO./ DESCRIPTION	BALANCE*	DATE DUE	INTEREST RATE	DATE THROUGH WHICH INTEREST IS PAID	DESCRIPTION OF COLLATERAL

______________________________ (Customer's Authorized Signature)

______________________________ (Date)

The information presented above by the customer is in agreement with our records. Although we have not conducted a comprehensive, detailed search of our records, no other deposit or loan accounts have come to our attention except as noted below.

______________________________ (Financial Institution Authorized Signature)

______________________________ (Date)

______________________________ (Title)

EXCEPTIONS AND/OR COMMENTS

Please return this form directly to our accountants:

[ ]

[ ]

* Ordinarily, balances are intentionally left blank if they are not available at the time the form is prepared.

Approved 1990 by American Bankers Association, American Institute of Certified Public Accountants, and Bank Administration Institute. Additional forms available from: AICPA—Order Department, P.O. Box 1003, NY, NY 10108-1003

D 451 5951

.05 Request for Confirmation of Petty Cash Fund and Advances to Employees

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of the petty cash fund (or amount of advances) in your possession as of December 31, 20XX which was shown by our records as $_______.

Please indicate in the following space provided whether the amount above agrees with your records. If not, please send the auditors any information you have that will help them reconcile the difference.

After signing and dating your reply, please return it directly to the auditors. A stamped, addressed enveloped is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

____

The foregoing information is in agreement with my records as of December 31, 20XX with the following exceptions (if any):

____

____

____

Date:______________________________ Signed:____________________________

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.06 Securities and Cash in Custodian or Trust Accounts

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Custodian or Trustee*]

[*Address*]

Our auditors, [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the enclosed list of securities owned at [*date*] and the amount of principal and income of cash held by you at that date for each of the following accounts:[1] [2]

[*If a list is not obtained from the client, the auditor may complete the following for each account:*

Name of Account	*Account No.*[3]	*Amount Held*
1.______________	______________	______________
2.______________	______________	______________
3.______________	______________	______________]

Please also indicate to the auditors whether or not 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.

Sincerely,

[*Client's Authorized Signature*]

---

[1] This letter may be expanded, if necessary, to request cutoff statements of activity (principal and interest) in the accounts.

[2] 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.

[3] Use the custodian or trustee's account number.

.07 Securities Held by Brokers

[*Prepared on Client's Letterhead*]

[*Date*]

[*Broker's Name*]

[*Address*]

In connection with the audit of our financial statements, please send directly to our auditors [*name and address of auditors*], a statement of our account(s) with you as of [*date*], indicating the following information:

1. Securities held by you for our account
2. Securities out for transfer to our name
3. Any amounts payable to or due from us

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

____

Notes:

(A) The request may 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).

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.08 Sample Receipts for Return of Cash or Securities Counted by Auditor's Representative and Cutoff Bank Statements Received Directly by the Auditors

Cash Count

The above detailed items were counted in my presence and returned to me intact by [*individual's name*], representative of [*auditor's firm name*].

[*Date and Time*] Custodian: ________________________________
[*Custodian's Signature*]

Securities Count

Received intact from [*individual's name*], representative of [*auditor's firm name*], the securities listed above contained in [*Box* ______] of the [*name of bank or custodian*] which were counted by him or her in my presence (or presented to him or her for count).

Date and Time: ____________________ Signed: ________________________________

Title: _________________________________

Cutoff Bank Statement(s)

Received intact from [*individual's name*], representative of [*auditor's firm name*], the cutoff bank statements and related paid checks for the [*period date range*] for the accounts listed in the following space provided:

Date and Time: ____________________ Signed: ________________________________

Title: _________________________________

Notes:

(A) The auditor may request that receipt(s) be written and signed in *ink*.

(B) For counts of petty cash funds, the receipt may be written directly on the bottom of the petty cash-count working paper. For security counts and returns of cutoff bank statements, the receipt may be prepared as a separate working paper.

.09 Accounts Receivable—Positive

[*Prepared on Client's Letterhead*]

[*Date*]

[*Customer Name*]

[*Address*]

In connection with the audit of our financial statements, please confirm directly to our auditors [*name and address of auditors*] the amount of your indebtedness to us which according to our records as of [*date*] amounted to $______.

If the amount shown is in agreement with your records, please check "A."

If the amount is not in agreement with your records, please check and complete "B."

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.

Sincerely,

[*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*]

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.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, who are now conducting an audit of our financial statements.

[*Name of auditors*]

____

[*Address of auditors*]

____

____

If you do not write to our auditors, they will consider this statement to be correct.

Remittances should NOT be sent to the auditors.

Notes:

(A) A negative confirmation may also be requested in letter form using similar wording.

(B) The auditor may consider sending confirmation requests at the time of the client's regular monthly billings. Coordination of confirmation procedures with the client's routine preparation and mailing of statements may offer efficiency to both the auditor and client.

(C) Negative confirmation requests may be used as substantive procedure to reduce audit risk *only* when three conditions exist: (1) the combined assessed level of inherent and control risk is low, (2) a large number of small balances is involved, and (3) the auditor has no reason to believe that the recipients of the request are unlikely to give them consideration.

.11 Notes Receivable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are performing an audit of our financial statements. Accordingly, please confirm directly to our auditors the amount of your indebtedness due us as of [*date*], which our records show as follows:

Type of indebtedness ______________________________

Initial date of indebtedness ______________________________

Original amount of indebtedness ______________________________

Unpaid principal ______________________________

Interest rate ______________________________

Interest paid to ______________________________

Periodic payments required ______________________________

Description of collateral ______________________________

If the above information is in agreement with your records, please so indicate by signing in the following space provided and then 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 following space provided the particulars shown in your records along with any information that may help reconcile the difference from our records. Payments should not be sent to the auditors.

Sincerely,

[*Client's Authorized Signature*]

The above information is correct as of [*date*] with the following exceptions (if any):

____

____

____

____

____

____

Signed: __________________________ Date: __________________________

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.12 Inventories Held by Warehouses or Others When Listing Is Not Provided by Client

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Warehouse*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please send directly to our auditors the following information about merchandise held in your custody for our account as of [*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
        - i. Number of units
        - ii. Kind of units (box, can, crate, quart, pound, dozen, or other unit)
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. A statement of any known liens against this merchandise.
5. The amount of unpaid charges, if any, as of [*date*].

Please mail your reply directly to the auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

.13 Inventories Held by Warehouses or Others When Listing Is Provided by Client

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Warehouse*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about the merchandise held by you for our account as of [*date*]:

1. The correctness of the quantities shown on the enclosed listing of such merchandise prepared from our records (a second copy is enclosed for your files). If the enclosed listing differs from the quantities you held for us as of [*date*], please include details of the specific differences in your response to our auditors.

2. Your statement on how you determined the correctness of the quantities you are confirming; please specify whether it was 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. A statement of any known liens against these goods.

5. The amount of any unpaid charges as of [*date*].

Please mail your reply directly to [*name and address of auditors*]. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

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.14 Standard Confirmation Inquiry for Life Insurance Policies

LIFE INSURANCE **STANDARD CONFIRMATION INQUIRY**

Developed by American Institute of Certified Public Accountants
Life Office Management Association
and Million Dollar Round Table

RETURN TO: [ ] Date:

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. Use the enclosed envelope to return the original directly to our accountant (see name to left).

[ ] Yours truly,

REPORT FROM INSURANCE COMPANY [ ]

____
(Name of owner as shown on policy contract)

By ______________________________
Authorized Signature

Information requested as of: ______________
(Date)

[ ]

Additional forms available from
AICPA-ORDER
PO BOX 0946
NYC, NY 10108-0946

		Policy #1	Policy #2	Policy #3
	A. Policy Number			
	B. Insured-Name(s)			
	C. Beneficiaries as Shown on Policies (If Verification Requested in Item 11)			
1 Face Amount of Basic Policy				
2 Values Shown as of (Insert Date If Other Than Date Requested)				
3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)				
4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)				
5 Surrender Value of All Dividend Credits, Including Accumulations & Additions				
6 Termination Dividend Currently Available on Surrender				
7 Other Surrender Values Available to Policy Owner	a. Prepaid Premium Value			
	b. Premium Deposit Funds			
	c. Other			
8 Outstanding Policy Loans, Excluding Accrued Interest				
9 If Any Policy Loans Exist, Complete Either "a" or "b"	a. Interest Accrued on Loans			
	b1. Loan Interest is Paid to (Enter Date)			
	b2. Interest Rate is (Enter Rate)			
NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (✓).				
☐ 10 Is There an Assignee of Record? (Enter Yes or No)				
☐ 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)		*	*	*
☐ 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: ☐ Yes ☐ No If No, Enter Name of Policy Owner of Record:				

* If Answer to Item 11 is "No." Please Give Name of Beneficiary or Date of Last Beneficiary Change:

Yours truly, (Insurance Company)

ORIGINAL
To be mailed to accountant

______________ Date ______________________ Authorized Signature - Title

LIFE INSURANCE STANDARD CONFIRMATION INQUIRY

Developed by American Institute of Certified Public Accountants
Life Office Management Association
and Million Dollar Round Table

RETURN TO: [ ]

[ ]

Date:

Your completion of the following report will be sincerely appreciated. IF THE ANSWER TO ANY ITEM IS "NONE," PLEASE SO STATE. Use the enclosed envelope to return the original directly to our accountant (see name to left).

Yours truly,

____
(Name of owner as shown on policy contract)

By ______________________________
Authorized Signature

REPORT FROM INSURANCE COMPANY [ ]

[ ]

Information requested as of: ______________
(Date)

Additional forms available from
AICPA-ORDER
PO BOX 0946
NYC, NY 10108-0946

		Policy #1	Policy #2	Policy #3
	A. Policy Number			
	B. Insured-Name(s)			
	C. Beneficiaries as Shown on Policies (If Verification Requested in Item 11)			
1 Face Amount of Basic Policy				
2 Values Shown as of (Insert Date If Other Than Date Requested)				
3 Premiums, Including Prepaid Premiums, Are Paid to (Insert Date)				
4 Policy Surrender Value (Excluding Dividends, Additions & Indebtedness Adjustments)				
5 Surrender Value of All Dividend Credits, Including Accumulations & Additions				
6 Termination Dividend Currently Available on Surrender				
7 Other Surrender Values Available to Policy Owner	a. Prepaid Premium Value			
	b. Premium Deposit Funds			
	c. Other			
8 Outstanding Policy Loans, Excluding Accrued Interest				
9 If Any Policy Loans Exist, Complete Either "a" or "b"	a. Interest Accrued on Loans			
	b1. Loan Interest is Paid to (Enter Date)			
	b2. Interest Rate is (Enter Rate)			
NOTE: PLEASE ANSWER ANY ITEM(s) 10–12 INDICATED BY A (✓).				
☐ 10 Is There an Assignee of Record? (Enter Yes or No)				
☐ 11 Is Beneficiary of Record as Shown in Item C. Above? (Enter Yes or No*)		*	*	*
☐ 12 Is the Name of Policy Owner (Subject to Any Assignment) as Shown on Top of Form: ☐ Yes ☐ No If No, Enter Name of Policy Owner of Record:				

* If Answer to Item 11 is "No." Please Give Name of Beneficiary or Date of Last Beneficiary Change:

Yours truly, (Insurance Company)

DUPLICATE

______________ Date

______________________________ Authorized Signature - Title

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.15 Pension Plan Actuarial Information

Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 715, *Compensation—Retirement Benefits*, provides reduced disclosure requirements for nonissuers. Part C of this letter assumes companies have elected the reduced disclosures allowed by that statement. "Pending Content" in FASB ASC 715-20-50-5 describes the reduced disclosure requirements. For companies not electing the reduced disclosures, information required for disclosure can be obtained from Parts B and D of the letter.

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Actuary*]

[*Address*]

In connection with the audit of our financial statements for the period ending [*balance sheet date*] by our independent auditors [*name and address of auditors*], please furnish them the information described as follows as it pertains to the XYZ Pension Plan, which is a defined benefit plan. For your convenience and in response to those requests, you may supply pertinent sections, properly signed and dated, of your actuarial or pension expense report if they are available and if they contain the requested information.

A. Please provide a brief description of the following:

1. The employee group covered.
2. The benefit provisions of the plan used in the calculation of the net periodic pension cost for the period and of the accumulated benefit obligation and the projected benefit obligation at the end of the period. Please identify any such benefit provisions that had not taken effect in the year. Please also provide the date of the most recent plan amendment included in your calculation. Please identify any participants or benefits excluded from the calculations, such as benefits guaranteed under an insurance or annuity contract.
3. The percentages of the plan's assets that are invested in debt securities, equity securities, real estate, and any additional classifications of investment. Please identify the target compositions, if any, for the aforementioned classifications of investment groups.
4. A narrative description of the plan's investment policies and strategies, and the basis used to determine the expected long term rate of return on plan assets.
5. The method and the amortization period, if any, used for the following:
   - *a.* Calculation of a market related value of plan assets, if different from the fair value
   - *b.* Amortization of any transition asset or obligation
   - *c.* Amortization of unrecognized prior service cost
   - *d.* Amortization of unrecognized net gain or loss
6. Any substantive commitments for benefits that exceed the benefits defined by the written plan that are included in the calculations.
7. Determination of the value of any insurance or annuity contracts included in the assets.
8. Nature and effect of significant plan amendments and other significant matters affecting comparability of net periodic pension cost, funded status, and other information for the current period with that for the prior period.
9. The following information relating to the employee census data used in calculating the benefit obligations and pension cost:

a. The source and nature of the data is ____________________ and the date as of which the census data was collected is __________________.

b. The following information concerning participants:

Participants	Number of Persons	Compensation (if applicable)
Currently receiving payments	________	________
Active with vested benefits	________	________
Terminated with deferred vested benefits	________	________
Active without vested benefits	________	________
Other (describe)	________	________

> ***Note:*** *If information is not available for all the above categories, please indicate the categories that have been grouped and describe any group or groups of participants excluded from the above information.*

c. Information for the following individuals contained in the census:

Participant's Name or Number	Age or Birth Date	Sex	Salary	Date Hired or Years of Service

> ***Note to Auditor:*** *The auditor may 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 or her files to compare with the employer's records.*

B. Please provide the following information on the net periodic pension cost for the period ending on __________:

1. Service cost $ ________
2. Interest cost ________
3. Expected return on assets ________
4. Other components ________
   a. Amortization of unrecognized net loss or (gain) from earlier periods ________
   b. Amortization of unrecognized prior service cost ________
   c. Amortization of the remaining unrecognized net obligation or (asset) existing at the date of the initial application of Financial Accounting Standards Board *Accounting Standards Codification* 715, *Compensation—Retirement Benefits*—transition obligation or (asset) ________
   d. Amount of loss (or gain) recognized due to a settlement or curtailment ________
   e. Net total of components (*a*+*b*+*c*+*d*) $ ________
5. Net periodic pension cost: (1+2-3+4*e*) $ ________
6. The above measurement of the net periodic pension cost is based on the following assumptions:
   Weighted average discount rate ________ %

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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 and B5 are based on the following:

Asset information ________

Census data ________

Measurement date (must not be more than three months before the end of the last fiscal year) ________

Please describe any adjustments made to project the census data forward to the measurement date or to project the results calculated at an earlier date to those shown in B1–B5.

C. Please provide the following information for disclosure in the financial statements for the period ending ______________:

		Estimated
1.	Projected benefit obligation	$ ________
2.	Fair value of plan assets	________
3.	Funded status of the plan (2-1)	________
4.	Employer contributions to the plan	________
5.	Participant contributions to the plan	________
6.	Benefits paid	________
7.	(Accrued) or prepaid pension cost in the company financial statements	________
8.	The amount of any intangible asset or liability that is recognized may result in a temporary difference, as defined by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740, *Accounting for Income Taxes*. The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated to various financial statement components, including other comprehensive income, pursuant to FASB ASC 740.	________
9.	The amount of any accumulated other comprehensive income or liability that is recognized may result in a temporary difference, as defined by FASB ASC 740. The deferred tax effects of any temporary differences shall be recognized in income tax expense or benefit for the year and shall be allocated to various financial statement components, including other comprehensive income, pursuant to FASB ASC 740.	________
10.	The amount included in other comprehensive income for the period arising from a change in the minimum pension liability recognized in accordance with FASB ASC 715, *Compensation—Retirement Benefits*.	________

11. The above amount of the projected benefit obligation is measured based on the following assumptions:

Weighted average discount rate ________ %

Weighted average rate of compensation increase ________ %

Please provide a brief description of the other assumptions used in the measurement.

12. The calculation of the items shown in C1–C10 is based on the following:

(continued)

	Estimated
Asset information	________
Census data	________
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–C10.

13. Please describe any significant events noted subsequent to the current year's measurement date and as of the date of your reply to this request and the effects of those events, such as a large plant closing, which could materially affect the amounts shown in C1–C10.
14. Please describe any significant transactions between the employer or related parties and the plan during the period, including, if applicable, the amounts and types of securities of the employer and related parties included in plan assets and the amount of future annual benefits covered by insurance contracts issued by the employer or related parties.

D. Please provide an analysis for the period showing beginning amounts, additions, reductions, and ending amounts of the

1. projected benefit obligation,
2. fair value of plan assets,
3. unrecognized prior service cost,
4. unrecognized net loss (gain),
5. net transition obligation (asset), and
6. accumulated benefit obligation (ending amount only).

E. Please provide our independent auditors with descriptions and the amounts of gains or losses from combinations, divestitures, settlements, curtailments, or termination benefits during the year, such as

1. purchases of annuity contracts,
2. lump sum cash payments to plan participants,
3. other irrevocable actions that relieved the company or the plan of primary responsibility for a pension obligation and eliminated significant risks related to the obligation and assets,
4. any events that significantly reduced the expected years of future service of employees,
5. any events that eliminated for a significant number of employees the accrual of defined benefits for some or all of their future service, or
6. any special or contractual termination benefits offered to employees.

F. Please provide the amounts of anticipated cash payments for benefits for each of the next 5 years, as well as the expected aggregate amount of benefit payments for the subsequent 5 year period (years 6–10).

G. Was all of the information above determined in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 715 and the American Academy of Actuaries', *An Actuary's Guide to Compliance with Statement of Financial Accounting Standards No. 87* to the best of your knowledge? If not, please describe any differences.

H. Describe the nature of your relationship, if any, with the plan or the plan sponsor that may impair or appear to impair the objectivity of your work.

Please mail your response directly to [*audit firm's name and address*] in the enclosed return envelope as soon as possible, but no later than [*date*].

Sincerely,
[*Client's Authorized Signature*]

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.16 Pension Plan Assets Held by Trustee

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Trustee or Custodian*]

[*Address*]

Our auditors [*name and address of auditor*] are conducting an audit of our financial statements. Accordingly, please provide our auditors directly with a listing of the assets including market values as of [*date*] for our employees' pension trust [*title and trustee's account number*].

Please also provide the auditors with the following information about our employees' pension trust for the period from [*beginning of period*] to [*end of period*]:[4]

1. Contributions by the Company during the above period
2. Contributions by employees during the above period
3. Payments to beneficiaries during the above period
4. Any unpaid fees due for services rendered to [*balance sheet date*]

Please send your reply directly to our auditors. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,
[*Client's Authorized Signature*]

[4] A listing of the assets might not be requested if one had already been received by the client. In that case, the auditor might want the trustee to confirm the total market value per the listing.

.17 Notes Payable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements.

Accordingly, please confirm directly to them the following information relating to our note(s) payable to you, as of [*date*]:

Date of note		________	
Original amount	$	________	
Unpaid principal			
Balance	$	________	
Periodic payments required	$	________	
Payment periods		________	
Maturity date		________	
Interest rate		________	%
Date to which interest has been paid		________	
Amount and description of collateral		________	
Description of terms (for example, demand provisions and prepayment penalties)		________	
Any other direct or contingent liabilities to you (please write "None" or provide description)		________	

If the above information is in agreement with your records at that date, please so indicate by signing in the following space provided 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 following space provided the particulars shown in your records and any information that may help reconcile the difference from our records.

Sincerely,
[*Client's Authorized Signature*]

____

The above information is correct as of [*date*] with the following exceptions (if any):

____

Date:________________________ Signature:________________________

Title:________________________

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.18 Mortgage Debt

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Creditor or Trustee*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information about our mortgage indebtedness to you as of [*date*]:

1.	Original amount	$	__________	
2.	Date of note		__________	
3.	Unpaid principal balance	$	__________	
4.	Interest rate		__________	%
5.	Terms for payment of principal		__________	
6.	Date to which interest has been paid		__________	
7.	Nature of mortgage and description or address of property mortgaged		__________	
8.	Amounts on deposit with you in escrow for			
	a. insurance	$	__________	
	b. real estate taxes	$	__________	
9.	Amounts paid during the period [*dates from and to*] for			
	a. insurance	$	__________	
	b. taxes	$	__________	
10.	Amounts on deposit with you for the reserve for repairs	$	__________	
11.	The nature of defaults, if any		__________	
12.	Description of terms (for example, prepayment penalties and demand provisions)		__________	

A return envelope is enclosed for your reply.

Sincerely,

[*Client's Authorized Signature*]

> ***Note:*** Many of the items requested will vary with the circumstance of the particular mortgage or other debt involved. The above sample assumes the indenture involves an escrow arrangement for insurance and real estate taxes and a deposit account for repairs.

.19 Accounts Payable

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

In connection with the audit of our financial statements, please confirm directly to our auditors [*name and address of auditors*], the amount of our liability to you as of [*date*]. Please attach a statement of our account due. If no balance is due, please attach a statement of our account showing payments made.

Please mail your reply directly to [*name of auditors*]. A stamped, addressed envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

Our records indicate that a balance of $________ was from [*name of client*] at [*date*].

Date: ____ Signature: ___________________________________

Title: ____

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.20 Obligation to Lessor

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lessor*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements as of [*balance sheet date*] and for the [*time period*] then ended. In connection with this audit, please provide directly to our auditors the following information as of [*balance sheet date*] regarding the lease dated [*date lease was executed*] of [*brief identification of property under lease*] that 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 a statement of the nature of defaults, if any

A return envelope is enclosed for your reply.

Sincerely,

[*Client's Authorized Signature*]

Note: The content of this type of letter will vary based on the auditor's professional judgment in the circumstances. To provide additional illustrative language, the above letter is not made parallel with the illustration in section 7200, "Requests for Confirmations and Related Materials," paragraph .23.

.21 Property Out on Lease

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lessee*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements as of [*balance sheet date*] and for the [*time period*] then ended. In connection with this audit, please confirm directly to our auditors the following information regarding the lease dated [*execution date of lease*] of [*brief identification of property under lease*] that you are leasing from us:

1. Inception and expiration dates of lease period from _______________ to _______________
2. Amount of monthly rent __________________
3. Total rent payments made ________________
4. Date of last payment ____________________

A return envelope is enclosed for your reply.

Sincerely,

[*Client's Authorized Signature*]

Notes:

(A) If the leased property is of a mobile or portable nature such as a bulldozer or television camera, the confirmation may also include a request for specific serial numbers of significant equipment.

(B) In certain circumstances, the auditor may wish to consider confirming additional information such as renewal options, purchase options, and amendments or supplementary understandings.

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.22 Register—Capital Stock

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Registrar*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of the close of business [*balance sheet date*] about each class of our preferred and common stock:

1. Authorized number of shares ____________________
2. Issued number of shares ______________________
3. Outstanding number of shares ___________________

Please also indicate the amount of any unpaid registrar fees due you as of [*balance sheet date*].

A return envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

The above information agrees with our records at [*balance sheet date*] with the following exceptions:

____

____

____

____

Signed: ______________________________________ Date: ______________________________________
[*Name and Title*]

Notes:

(A) It may be helpful to include the registrar's account number for the client's account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) The above illustration assumes the client has a separate transfer agent (see section 7200 paragraph .25).

.23 Transfer Agent—Capital Stock

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Transfer Agent*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the following information as of [*balance sheet date*] about each class of our preferred and common stock:

1. Authorized number of shares ____________________
2. Number of shares issued and outstanding ____________________
3. Number of outstanding shares registered in the name of our Company ____________________

Please also indicate the amount of any unpaid transfer agent fees due you as of [*balance sheet date*].

A return envelope is enclosed for your convenience.

Sincerely,

[*Client's Authorized Signature*]

The above information agrees with our records at [*balance sheet date*] with the following exceptions:

____

____

____

____

Signed: ____________________ Date: ____________________
[*Name and Title*]

Notes:

(A) It may be helpful to include the transfer agent's account number for the client's account to receive a timely response.

(B) Some auditors prefer that the confirmation request include identification of each class of stock.

(C) Depending on the auditor's judgment in the circumstances the confirmation request may also include inquiries about such matters as (1) the number of shares issued to each of specifically mentioned officers and directors, (2) specified information about shareholders owning more than a stated percent of the total outstanding shares, and (3) amounts deposited during the year for the payment of dividends.

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.24 Request for Confirmation of Money Market Fund

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

Our auditors [*name and address of auditors*] are conducting an audit of our financial statements. Accordingly, please confirm directly to our auditors the balance of our money market fund account(s) as of [*date*].

Please indicate in the following space provided 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.

Sincerely,

[*Client's Authorized Signature*]

____

Account No.	*Date*	*Balance*

Date: ______________________ Signed: ______________________

.25 Confirmation of Contingent Liabilities

[*Date*]

Financial Institution Official[5]

First United Bank
Anytown, USA 00000

In connection with an audit of the financial statements of [*name of customer*] as of [*balance sheet date*] and for the [*period*] then ended, we have advised our independent auditors of the following listed information, which we believe is a complete and accurate description of our contingent liabilities, including oral and written guarantees, with your financial institution. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other contingent liabilities, including oral and written guarantees, from your financial institution comes to your attention, please include such information in the following space provided.

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 providing a signature below and returning this directly to our independent auditors [*name and address of CPA firm*].

Sincerely,

[*Name of Customer*]

____

By: ______________________________

[*Authorized Signature*]

____

[5] 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.

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Dear CPA Firm:

The above information listing contingent liabilities, including oral and written guarantees, agrees with the records of this financial institution.[6] Although we have not conducted a comprehensive, detailed search of our records, no information about other contingent liabilities, including oral and written guarantees, came to our attention. (Note exceptions below or in an attached letter.)

____

____

____

____

____

____

[*Name of Financial Institution*]

By: _______________________ _______________

[*Officer*] [*Date*]

____

[*Title*]

[6] If applicable, comments similar to the following may be added to the confirmation reply by the financial institution: This confirmation does not relate to arrangements, if any, with other branches or affiliates of this financial institution. Information should be sought separately from such branches or affiliates with which any such arrangements might exist.

.26 Confirmation of Compensating Balances

[*Date*]

Financial Institution Official[7]

First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [*name of customer*] as of [*balance sheet date*] and for the [*period*] then ended, we have advised our independent auditors that as of the close of business on [*balance sheet date*] there (were) (were not) compensating balance arrangements as described in our agreement dated [*date*]. Although we do not request nor expect you to conduct a comprehensive, detailed search of your records, if during the process of completing this confirmation additional information about other compensating balance arrangements between [*name of customer*] and your financial institution comes to your attention, please include such information below. Withdrawal by [*name of customer*] of the compensating balance (was) (was not) legally restricted at [*date*]. The terms of the compensating arrangements at [*date*] were:

EXAMPLES:

1. The Company has been expected to maintain an average compensating balance of 20 percent of its average loan understanding, as determined from the financial institution's ledger records adjusted for estimated average uncollected funds.
2. The Company has been expected to maintain an average compensating balance of $100,000 during the year, as determined from the financial institution's ledger records without adjustment for uncollected funds.
3. The Company has been expected to maintain a compensating balance, as determined from the financial institution's ledger records without adjustment for uncollected funds, of 15 percent of its outstanding loans plus 10 percent of its unused line of credit.
4. The Company has been expected to maintain as a compensating balance noninterest bearing time deposits of 10 percent of its outstanding loans.

In determining compliance with compensating balance arrangements, the Company uses a factor for uncollected funds of _____ [*business calendar*] days.[8]

There (were the following) (were no) changes in the compensating balance arrangements during the [*period*] and subsequently through the date of this letter.

The Company (was) (was not) in compliance with the compensating balance arrangements during the [*period*] and subsequently through the date of this letter.

There (were the following) (were no) sanctions (applied or imminent) by the financial institution because of noncompliance with compensating balance arrangements.[9]

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.)

---

[7] 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.

[8] This is 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.

[9] This is applicable only if the financial institution has applied sanctions during the [*period*] or notified the Company that sanctions may be applied. Indicate details.

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Please confirm whether the information about compensating balances presented above is correct by signing in the following space provided 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.[10] 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 in the following space provided or in an attached letter.)

____

____

____

____

____

____

[*Name of Financial Institution*]

By: ____________________________ ________________

[*Officer*] [*Date*]

____

[*Title*]

---

[10] See footnote 6.

.27 Confirmation of Lines of Credit

[*Date*]

Financial Institution Official[11]

First United Bank
Anytown, USA 00000

Dear Financial Institution Official:

In connection with an audit of the financial statements of [*name of client*] as of [*balance sheet date*] and for the [*period*] then ended, we have advised our independent auditors of the following information that 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 in the following space provided.

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 _____ percent.

Compensating balance arrangements are:

____

____

____

____

This line of credit supports commercial paper (or other borrowing arrangements) as described in the following space provided:

____

____

____

Please confirm whether the information about lines of credit presented above is correct by signing in the following space provided and returning this letter directly to our independent auditors [*name and address of CPA Firm*].

Sincerely,

[*Name of Client*]

____

By: ______________________________

[*Authorized Signature*]

---

[11] This letter should be addressed to a financial institution official who is responsible for the financial institution's relationship with the client or is knowledgeable about the 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.

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Dear CPA Firm:

The above information regarding the line of credit arrangements agrees with the records of this financial institution.[12] 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 in the following space provided or in an attached letter.)

____

____

____

____

____
[*Name of Financial Institution*]

By: ______________________ ____________
[*Officer*] [*Date*]

____
[*Title*]

[12] See footnote 6.

.28 Related Party Confirmation

In certain situations, the auditor may want to confirm the existence of related parties with directors, principal officers, major shareholders, or others. For example, a company does not have adequate controls and processes in place to identify related party transactions and the auditor has not otherwise been satisfied as to the extent of related party transactions. The following is an illustrative related party confirmation letter that an auditor may use when the auditor is not otherwise satisfied as to the extent of related party transactions.

[*Date*]

[*Name of Director, Principal Officer, or Major Stockholder*]

[*Address*]

Dear [*Name*]:

In connection with an audit of our financial statements, please furnish answers to the attached questionnaire, sign your name, and return the questionnaire in the enclosed stamped, addressed envelope directly to our auditors [*name and address of auditors*]. The questionnaire is designed to provide the auditors with information about the interests of officers, directors, and other related parties in transactions with the Company.

Please answer all questions. If the answer to any question is "yes," please explain why it is so. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions. Thank you for your cooperation.

Sincerely,

____

[*Client's Authorized Signature*]

____

[*Title*]

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[*Client Name*]

Related Party Questionnaire

Please answer all questions. If the answer to any question is "yes," please explain why it is so. Certain terms used in the questions are defined at the end of the questionnaire. Please read the definitions carefully before answering the questions.

1. Have you or any related party of yours had any interest, direct or indirect, in any sales, purchases, transfers, leasing arrangements, guarantees, or other transactions since [*beginning of period of audit*] to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) was, or is to be, a party?

2. Do you or any related party of yours have any interest, direct or indirect, in any pending or incomplete sales, purchases, transfers, leasing arrangements, guarantees or other transactions to which the Company (or specify any pension, retirement, savings, or similar plan provided by the client) is, or is to be, a party?

3. Have you or any related party of yours been indebted to the Company (or specify any pension, retirement, savings, or similar plan provided by the client) at any time since [*beginning of period of audit*]? Please exclude amounts due for purchases on usual trade terms and for ordinary travel and expense advances.

The answers to the foregoing questions are correct to the best of my knowledge and belief.

____

[*Signature*] [*Date*]

Definitions

company. Parent company, any subsidiary or investee for which investments are accounted for by the equity method.

related party. Any (1) party (other than the Company) of which you are an officer, director, or partner or are, directly or indirectly, the beneficial owner of 10 percent or more of the voting interests; (2) any trust or other estate in which you have a substantial beneficial ownership or for which you serve as a trustee or in a similar fiduciary capacity; (3) any member of your immediate family; and (4) other party with which you may deal if you (or the other party) control or can significantly influence the other to an extent that either of you might be prevented from fully pursuing your own separate interests.

control. Possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a party, whether through ownership, by contract, or otherwise.

party. An individual, a corporation, a partnership, an association, a joint stock company, a business trust, or an unincorporated organization.

beneficial owner. Party who enjoys, or has the right to secure, benefits substantially equivalent to those of the ownership of securities, even though the securities are not registered in the party's name. Examples of beneficial ownership include securities held for the party's benefit in the name of others, such as nominees, custodians, brokers, trustees, executors, and other fiduciaries; a partnership of which the person is a partner; and a corporation for which the party owns substantially all of the stock. Shares (1) held (individually or in a fiduciary capacity) by the party's spouse, the party's or his or her spouse's minor children, or a relative of the party or his or her spouse who shares the same home with the party; or (2) that the party can vest or revest title in himself or herself at once or at some future time are also considered as being beneficially owned.

.29 Safe Deposit Box Access Confirmation

[*Date*]

[*Name*]

[*Address*]

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 following space provided if the previous statement 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.

Sincerely,

____

[*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*]

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.30 Insurance In Force Confirmation Request

[*Date*]

[*Name*]

[*Address*]

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 in the following space provided:

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 following space, if it is or is not in agreement with your records. After signing and dating your reply, please mail it directly to our auditors in the enclosed envelope.

Sincerely,

____

[*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 Audit Inquiry Letter to Legal Counsel[2]

[*Prepared on Client's Letterhead*][3]

[*Date*][4]

[*Name of Lawyer*]

[*Address of Lawyer*]

Dear [*Name*]:

In connection with an audit of our financial statements at (balance sheet date) and for the (period) then ended, management of the Company has prepared, and furnished to our auditors (name and address of auditors), a description and evaluation of certain contingencies, including those set forth below involving matters with respect to which you have been engaged and to which you have devoted substantive attention on behalf of the Company in the form of legal consultation or representation. These contingencies are regarded by management of the Company as material for this purpose (management may indicate a materiality limit if an understanding has been reached with the auditor). Your response should include matters that existed at (balance sheet date) and during the period from that date to the date of your response.

Pending or Threatened Litigation (excluding unasserted claims)

[Ordinarily the information would include the following: (1) the nature of the litigation, (2) the progress of the case to date, (3) how management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement), and (4) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated and an identification of the omission of any pending or threatened litigation, claims, and assessments or a statement that the list of such matters is complete.

Unasserted Claims and Assessments (considered by management to be probable of assertion, and that, if asserted, would have at least a reasonable possibility of an unfavorable outcome)

[Ordinarily management's information would include the following: (1) the nature of the matter, (2) how management intends to respond if the claim is asserted, and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.] Please furnish to our auditors such explanation, if any, that you consider necessary to supplement the foregoing information, including an explanation of those matters as to which your views may differ from those stated.

---

[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 or she has not obtained a letter from legal counsel of the Company. In these circumstances, the auditor may consider obtaining written representation from the Company that legal counsel has not been retained for matters concerning business operations that may involve current or prospective litigation. Auditing Interpretation No. 6, "Client Has Not Consulted a Lawyer," of AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, AU sec. 9337 par. .15–.17), provides guidance for auditors when the client has not retained legal counsel during the period under audit.

[2] Extracted from AU section 337A, *Illustrative Audit Inquiry Letter to Legal Counsel* (AICPA, *Professional Standards*), the appendix to AU section 337. (See footnote 4.)

[3] Paragraph .09 of AU section 337 discusses the matters that should be covered in a letter of audit inquiry.

[4] Sending of this letter should be timed so that the lawyer's response is dated as close to the auditor's opinion date as practical. However, the auditor and client may consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

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 Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*. 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.]

Sincerely,

[*Authorized Signature for Client*]

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.02 Illustrative Inquiry Letter to Legal Counsel If Management Has Not Provided Details About Pending or Threatened Litigation

[*Prepared on Client's Letterhead*]

[*Date*]

[*Name of Lawyer*]

[*Address of Lawyer*]

In connection with an audit of our financial statements at [*balance sheet date*] and for the [*period*] then ended, please furnish to our auditors [*name and address of auditors*] the information requested below for which you have been engaged to provide legal consultation or representation.

Pending or Threatened Litigation, Claims and Assessments

(excluding unasserted claims and assessments)

Please furnish a list of all pending or threatened litigation, claims, and assessments your firm is handling on our behalf including the following:

1. The nature of the litigation (including the amount of monetary or other damages sought)
2. The progress of the case to date
3. How management is responding or intends to respond to the litigation (for example, to contest the case vigorously or to seek an out-of-court settlement)
4. An evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss

Unasserted Claims and Assessments

We understand that whenever, in the course of performing legal services for us with respect to a matter recognized to involve an unasserted possible claim or assessment that may call for financial statement disclosure, if you have formed a professional conclusion that we should disclose or consider disclosing concerning such possible claim or assessment, you will so advise us and will consult with us concerning the question of such disclosure and the applicable requirements of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*, as a matter of professional responsibility to us. *Please specifically confirm to our auditors that our understanding is correct*.

We have represented to our auditors that there are no unasserted claims which are not specifically identified in this letter that you advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450.

(If unasserted claims exist, management's listed information should include the following: (1) the nature of the matter; (2) how management intends to respond if the claim is asserted; and (3) an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss.)

Please furnish our auditors with any explanation you consider necessary to supplement the foregoing information, including an explanation of these matters as to which your views may differ from those stated.

Please specifically identify the nature of and reasons for any limitation on your response.

[The auditor may request the client to inquire about additional matters, for example, unpaid or unbilled charges or specified information on certain contractually assumed obligations of the organization, such as guarantees of indebtedness of others.]

Sincerely,
[*Authorized Signature for Client*]

Notes:

(A) Paragraph .09 of AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*), discusses the matters that should be covered in a letter of audit inquiry.

(B) The 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 may consider early mailing of a draft inquiry as a convenience for the lawyer in preparing a timely response to the formal inquiry letter.

(C) If a client has not needed to retain legal counsel, an unqualified opinion may be expressed on the financial statements even though a letter from legal counsel has not been obtained. In these circumstances, the auditor may consider obtaining a written representation from the Company that legal counsel has not been retained for matters concerning its operations that involve current or prospective litigation. Interpretation No. 6, "Client Has Not Consulted a Lawyer," of AU section 337 (AICPA, *Professional Standards*, AU sec. 9337 par. .15–.17), provides guidance for auditors when the client has not retained legal counsel during the period under audit.

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.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 paragraph .10 of AU section 337 provides for such a conference. However, to improve the auditor's ability to receive all of the information necessary to complete his or her audit, he or she may consider the following matters in an inquiry to legal counsel:

a. A request that the attorney specify the effective date of his or her response if it is other than the date of the reply.

b. A request that the attorney mail the response so that it will be received by a certain date.

c. A request that the nature of any litigation specifically identify (1) the proceedings, (2) the claim(s) asserted, (3) the amount of monetary damages sought, or if no amounts are indicated in preliminary case filings, a statement to that effect, and (4) 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 or her reasons for that position.

f. A request that the attorney specify to what extent potential damages are covered by insurance. (It may be possible to obtain the opinion of the insurer's counsel regarding the applicability of insurance coverage.)

g. A request that the attorney provide a summary of material litigation, claims, and assessments settled during the period.

h. A statement that confirmation of the understanding regarding disclosure of unasserted claims and assessments is an integral part of the audit inquiry and that failure to so confirm will require a follow-up contact.

i. A statement that the attorney's response will not be quoted or referred to in the financial statements without first consulting with him or her.

[*The next page is 7401.*]

AAM Section 7400

Management Representations and Representation Letters

.01 AU section 333, *Management Representations* (AICPA, *Professional Standards*), states that written representations from management should be obtained for all financial statements and periods covered by the auditor's report. The specific written representations obtained by the auditor will depend on the circumstances of the engagement and the nature and basis of presentation of the financial statements.[1]

.02 Written representations from management ordinarily confirm representations explicitly or implicitly given to the auditor, indicate and document the continuing appropriateness of such representations, and reduce the possibility of misunderstanding concerning the matters that are the subject of the representations. Such representations from management are part of the audit evidence the independent auditor obtains, but they are not a substitute for the application of those auditing procedures necessary to afford a reasonable basis for an opinion regarding the financial statements under audit.

Specific Representations

.03 In connection with an audit of financial statements presented in accordance with generally accepted accounting principles (GAAP), specific representations should relate to the following matters:

Financial Statements

a. Management's acknowledgment of its responsibility for the fair presentation in the financial statements of financial position, results of operations, and cash flows in conformity with GAAP.

b. Management's belief that the financial statements are fairly presented in conformity with GAAP.

Completeness of Information

c. Availability of all financial records and related data.

d. Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.

e. Communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

f. Absence of unrecorded transactions.

[1] AICPA Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), provides nonauthoritative guidance for auditors when conducting audits in accordance with generally accepted auditing standards. TIS section 9100.06 discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. TIS section 9100.06 indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.

Recognition, Measurement, and Disclosure

g. Management's belief that the effects of any uncorrected financial statement misstatements[2] aggregated by the auditor during the current engagement and pertaining to the latest period presented are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[3] (A summary of such items should be included in or attached to the letter.)[4]

h. Management's acknowledgement of its responsibility for the design and implementation of programs and controls to prevent and detect fraud.

i. Knowledge of fraud or suspected fraud affecting the entity involving (1) management, (2) employees who have significant roles in internal control, or (3) others where the fraud could have a material effect on the financial statements.

j. Knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

k. Plans or intentions that may affect the carrying value or classification of assets or liabilities.

l. Information concerning related party transactions and amounts receivable from or payable to related parties.

m. Guarantees, whether written or oral, under which the entity is contingently liable.

n. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with the Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 275, *Risks and Uncertainties*.

o. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

p. Unasserted claims or assessments that the entity's lawyer has advised are probable of assertion and must be disclosed in accordance with FASB ASC 450, *Contingencies*.[5]

q. Other liabilities and gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

r. Satisfactory title to assets, liens or encumbrances on assets, and assets pledged as collateral.

s. Compliance with aspects of contractual agreements that may affect the financial statements.

Subsequent Events

t. Information concerning subsequent events.

The representation letter ordinarily should be tailored to include additional appropriate representations from management concerning matters specific to the entity's business or industry.

[2] Paragraph .07 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), states that a misstatement can result from errors or fraud and provides guidance for the auditor's evaluation of audit findings. (See AU section 312 par. .50–.61.)

[3] If management believes that certain identified items are not misstatements, management's belief may be acknowledged by adding to the representation (for example, "We do not agree that items XX and XX constitute misstatements because [*description of reasons*]").

[4] AU section 312 states that the auditor may designate an amount below which misstatements need not be accumulated. Similarly, the summary of uncorrected misstatements included in or attached to the representation letter need not include such misstatements. The summary should include sufficient information to provide management with an understanding of the nature, amount, and effect of the uncorrected misstatements. Similar items may be aggregated.

[5] If the entity has not consulted a lawyer regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments; see Interpretation No. 6, "Client Has Not Consulted a Lawyer" of AU section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, AU sec. 9337 par. .15–.17).

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Materiality Considerations

.04 Management's representations may be limited to matters that are considered either individually or collectively material to the financial statements, provided management and the auditor have reached an understanding on materiality for this purpose. Materiality may be different for different representations. A discussion of materiality may be included explicitly in the representation letter, in either qualitative or quantitative terms. Materiality considerations would not apply to those representations that are not directly related to amounts included in the financial statements.

Addressing and Dating

.05 The written representations should be addressed to the auditor. Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to or disclosure in the financial statements, the representations should be made as of the date of the auditor's report.

Management's Signatures

.06 The letter should be signed by those members of management with overall responsibility for financial and operating matters whom the auditor believes are responsible for and knowledgeable about, directly or through others in the organization, the matters covered by the representations. Such members of management normally include the chief executive officer and chief financial officer or others with equivalent positions in the entity.

Scope Limitations

.07 Management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion and is ordinarily sufficient to cause an auditor to disclaim an opinion or withdraw from the engagement. However, based on the nature of the representations not obtained or the circumstances of the refusal, the auditor may conclude that a qualified opinion is appropriate. Further, the auditor should consider the effects of the refusal on his or her ability to rely on other management representations.

Illustrative Representation Letter—Audit of Financial Statements

.08 The following letter, which relates to an audit of financial statements prepared in conformity with GAAP, is presented for illustrative purposes only. The introductory paragraph should specify the financial statements and periods covered by the auditor's report (for example, "balance sheets of XYZ Company as of December 31, 20X1 and 20X0, and the related statements of income and retained earnings and cash flows for the years then ended"). The written representations to be obtained should be based on the circumstances of the engagement and the nature and basis of presentation of the financial statements being audited.

.09 If matters exist that should be disclosed to the auditor, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred...." In appropriate circumstances, item 9 could be modified as follows: "The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities, except for its plans to dispose of segment A, as disclosed in Note X to the financial statements, which are discussed in the minutes of the December 7, 20X1, meeting of the board of directors." Similarly, if management has received a communication regarding an allegation of fraud or suspected fraud, item 8 could be modified as follows: "Except for the allocations discussed in the minutes of the December 7, 20X1, meeting of the board of directors (or disclosed to you at our meeting on October 15, 20X1), we have no knowledge of any allegations of fraud or suspected

fraud affecting the company received in communications from employees, former employees, analysts, regulators, short sellers, or others."

.10 The qualitative discussion of materiality used in the illustrative letter is adapted from FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information.*

.11 Certain terms are used in the illustrative letter that are described elsewhere in authoritative literature. Examples are *fraud*, in AU section 316, *Consideration of Fraud in a Financial Statement Audit*, (AICPA, *Professional Standards*), and *related parties* in footnote 1 of AU section 334, *Related Parties* (AICPA, *Professional Standards*). To avoid misunderstanding concerning the meaning of such terms, the auditor may wish to furnish those definitions to management or request that the definitions be included in the written representations.

.12 The illustrative letter assumes that management and the auditor have reached an understanding on the limits of materiality for purposes of the written representations. However, it should be noted that a materiality limit would not apply for certain representations, as explained in paragraph .08 of AU section 333.

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.13 Illustrative Representation Letter

[*Prepared on Client's Letterhead*]

[*Date*]

To [*Independent Auditor*]

We are providing this letter in connection with your audit(s) of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods*] for the purpose of expressing an opinion as to whether the [*consolidated*] financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [*name of entity*] in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the [*consolidated*] financial statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.

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

We confirm, to the best of our knowledge and belief, [*as of (date of auditor's report),*] the following representations made to you during your audit(s).

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.

2. We have made available to you all—

   a. Financial records and related data.

   b. Minutes of the meetings of stockholders, directors, and committees of directors, or summaries of actions of recent meetings for which minutes have not yet been prepared.

3. There have been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices.

4. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.

5. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[6]

6. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.

7. We have no knowledge of any fraud or suspected fraud affecting the entity involving—

   a. Management,

   b. Employees who have significant roles in internal control, or

   c. Others where the fraud could have a material effect on the financial statements.

8. We have no knowledge of any allegations of fraud or suspected fraud affecting the entity received in communications from employees, former employees, analysts, regulators, short sellers, or others.

---

[6] If management believes that certain of the identified items are not misstatements, management's belief may be acknowledged by adding to the representation, for example, "We do not agree that items XX and XX constitute misstatements because [*description of reasons*]."

9. The company has no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.

10. The following have been properly recorded or disclosed in the financial statements:

 a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.

 b. Guarantees, whether written or oral, under which the company is contingently liable.

 c. Significant estimates and material concentrations known to management that are required to be disclosed in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 275, *Risks and Uncertainties*. [*Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year*.]

11. There are no—

 a. Violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

 b. Unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450, *Contingencies*.[7]

 c. Other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

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

13. The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of noncompliance.

[*Add additional representations that are unique to the entity's business or industry. See paragraph .07* and appendix B, paragraph .17of this section.]

To the best of our knowledge and belief, no events have occurred subsequent to the balance-sheet date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

Notes: Depending on the nature, materiality, and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about

- the appropriateness of the measurement methods, including related assumptions used by management in determining the fair value and the consistency in application of the methods;
- the completeness and adequacy of disclosures related to fair values; and

[7] In the circumstance discussed in footnote 5 of this section, this representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

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- whether subsequent events require adjustments to the fair value measurements and disclosures are included in the financial statements.

[Source: Paragraph .49 of AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*)]

See appendix C of AU section 722, *Interim Financial Information* (AICPA, *Professional Standards*), for "Illustrative Management Representation Letters for a Review of Interim Financial Information."

.14 Illustrative Representation Letter—Audit of Personal Financial Statements

[*Date*]

[*To the Independent Auditor*]

We are providing this letter in connection with your audit of the statement of financial condition of James and Jane Person as of [*date*] and the related statement of changes in net worth for the [*period*] then ended for the purpose of expressing an opinion as to whether the financial statements present fairly, in all material respects, the financial condition and changes in the net worth, of James and Jane Person in conformity with accounting principles generally accepted in the United States of America. We confirm that we are responsible for the fair presentation in the statement of financial condition and changes in net worth in conformity with generally accepted accounting principles.

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

We confirm, to the best of our knowledge and belief, [*as of (date of auditor's report)*,] the following representations made to you during your audit.

1. The financial statements referred to above are fairly presented in conformity with accounting principles generally accepted in the United States of America.
2. We have made available to you all financial records and related data.
3. There are no material transactions that have not been properly recorded in the accounting records underlying the financial statements.
4. We believe that the effects of the uncorrected financial statement misstatements summarized in the accompanying schedule are immaterial, both individually and in the aggregate, to the financial statements taken as a whole.
5. We acknowledge our responsibility for the design and implementation of programs and controls to prevent and detect fraud.
6. We have no knowledge of any fraud or suspected fraud affecting
   a. us.
   b. others where the fraud could have a material effect on the financial statements.
7. We have no knowledge of any allegations of fraud or suspected fraud affecting us received in communications from analysts, regulators, short sellers, or others.
8. We have no plans or intentions that may materially affect the carrying value or classification of assets and liabilities.
9. The following have been properly recorded or disclosed in the financial statements:
   a. Related-party transactions, including sales, purchases, loans, transfers, leasing arrangements, and guarantees, and amounts receivable from or payable to related parties.
   b. Guarantees, whether written or oral, under which we are contingently liable.
   c. Significant estimates and material concentrations known to us that are required to be disclosed in accordance with Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 275, *Risks and Uncertainties*. (*Significant estimates are estimates at the balance sheet date that could change materially within the next year. Concentrations refer to volumes of business, revenues, available sources of supply, or markets or geographic areas for which events could occur that would significantly disrupt normal finances within the next year.*)

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10. There are no

    a. violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

    b. unasserted claims or assessments that our lawyer has advised us are probable of assertion and must be disclosed in accordance with FASB ASC 450, *Contingencies*.[8]

    c. other liabilities or gain or loss contingencies that are required to be accrued or disclosed by FASB ASC 450.

11. We have satisfactory title to all owned assets, and there are no liens or encumbrances on such assets nor has any asset been pledged as collateral.

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

To the best of our knowledge and belief, no events have occurred subsequent to the statement of financial condition date and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____
(James Person)

____
(Jane Person)

---

[8] Footnote 7 of AU section 333 states that if a lawyer has not been consulted regarding litigation, claims, and assessments, the auditor normally would rely on the review of internally available information and obtain a written representation by management regarding the lack of litigation, claims, and assessments. In the circumstances discussed in footnote 7 to AU section 333, this representation might be worded as follows:

> We are not aware of any pending or threatened litigation, claims, or assessments or unasserted claims or assessments that are required to be accrued or disclosed in the financial statements in accordance with Financial Accounting Standards Board *Accounting Standards Codification* 450, *Contingencies*, and we have not consulted a lawyer concerning litigation, claims, or assessments.

Interpretation No. 6 of AU section 337 also provides guidance for auditors when the client has not retained legal counsel during the period under audit.

.15 Illustrative Representation Letter to Other Accountants

[*Firm's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

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 that, in our judgment, would have a material effect upon the financial statements covered by your report, we shall notify you promptly.

Sincerely,

____

[*Engagement Partner's Signature*]

Note:If any matters come to the firm's attention that may require revision of the previous financial statements, they could be included in a separate paragraph after approval by the engagement partner.

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.16 Letter to Other Accountants Upon Whose Work We Plan to Rely

[*Firm's Letterhead*]

[*Date*]

[*Name*]

[*Address*]

We are auditing the financial statements of [*client's name*], [*parent company*]. The financial statements of [*other accountants' client's name*] that you are auditing are to be included in the financial statements of [*client's name*]. We will rely on your report on the financial statements in expressing an opinion on the (consolidated) financial statements of [*client's name*] (and subsidiaries). In that connection, we will refer to your report.

Please confirm to us that your firm is independent with respect to [*client's name*] and [*other accountant's client's name*] within the meaning of Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .01), of the Code of Professional Conduct.

Please provide us promptly, in writing, with the following information in connection with your current examination of the financial statements of [*other accountant's client's name*] with respect to the following:

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*].

Sincerely,

____

[*Engagement Partner's Signature*]

.17 Illustrative Updating Management Representation Letter

The following letter is presented for illustrative purposes only. It may be used in the circumstances described in paragraph .12 of AU section 333. Management need not repeat all of the representations made in the previous representation letter.

If matters exist that should be disclosed to the auditor, they should be indicated by modifying the related representation. For example, if an event subsequent to the date of the balance sheet has been disclosed in the financial statements, the final paragraph could be modified as follows: "To the best of our knowledge and belief, except as discussed in Note X to the financial statements, no events have occurred. …"

[*Firm's Letterhead*]

[*Date*]

To [*Auditor*],

In connection with your audit(s) of the [*identification of financial statements*] of [*name of entity*] as of [*dates*] and for the [*periods*] for the purpose of expressing an opinion as to whether the (consolidated) financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of [*name of entity*] in conformity with accounting principles generally accepted in the United States of America, you were previously provided with a representation letter under date of [*date of previous representation letter*]. No information has come to our attention that would cause us to believe that any of those previous representations should be modified.

To the best of our knowledge and belief, no events have occurred subsequent to [*date of latest balance sheet reported on by the auditor*] and through the date of this letter that would require adjustment to or disclosure in the aforementioned financial statements.

____

[*Name of Chief Executive Officer and Title*]

____

[*Name of Chief Financial Officer and Title*]

[*The next page is 7501.*]

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AAM Section 7500

Communication With Those Charged With Governance

.01 AU section 380, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*), establishes standards and provides guidance on the auditor's communication with those charged with governance in relation to an audit of financial statements. The term *those charged with governance* means the person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. For entities with a board of directors, the term encompasses the term *board of directors* or *audit committee* used elsewhere in generally accepted auditing standards (GAAS). Recognizing the importance of effective two-way communication to the audit, AU section 380 provides a framework for the auditor's communication with those charged with governance and identifies some specific matters to be communicated with them.

Matters to Be Communicated

.02 In accordance with paragraph .05 of AU section 380, the auditor must communicate with those charged with governance matters related to the financial statement audit that are, in the auditor's professional judgment, significant and relevant to the responsibilities of those charged with governance in overseeing the financial reporting process. The auditor should communicate the following with those charged with governance:

a. The auditor's responsibilities under GAAS, including that

   i. the auditor is responsible for forming and expressing an opinion about whether the financial statements that have been prepared by management with the oversight of those charged with governance are presented fairly, in all material respects, in conformity with generally accepted accounting principles (GAAP); and

   ii. the audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

   These responsibilities may be communicated through the engagement letter, or other form of contract that records the terms of the engagement, if that letter or contract is provided to those charged with governance. See paragraphs .26–.28 of AU section 380 for additional guidance.

b. An overview of the planned scope and timing of the audit. See paragraphs .29–.33 of AU section 380 for additional guidance.

c. Significant findings from the audit, including

   i. the auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, accounting estimates, and financial statement disclosures (see paragraphs .37–.38 of AU section 380);

   ii. significant difficulties, if any, encountered during the audit (see paragraph .39 of AU section 380);

   iii. uncorrected misstatements, other than those the auditor believes are trivial, if any (see paragraphs .40–.41 of AU section 380);

   iv. disagreements with management, if any (see paragraph .42 of AU section 380); and

v. other findings or issues, if any, arising from the audit that are, in the auditor's professional judgment, significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

.03 Unless all of those charged with governance are involved in managing the entity, the auditor also should communicate the following:

a. Material, corrected misstatements that were brought to the attention of management as a result of audit procedures. The auditor also may communicate other corrected immaterial misstatements, such as frequently recurring immaterial misstatements that may indicate a particular bias in the preparation of the financial statements.

b. Representations the auditor is requesting from management. The auditor may provide those charged with governance with a copy of management's written representations.

c. Management's consultations with other accountants (see paragraph .43 of AU section 380).

d. Significant issues, if any, arising from the audit that were discussed, or were the subject of correspondence, with management (see paragraph .44 of AU section 380).

The Communication Process

.04 The auditor should communicate with those charged with governance the form, timing, and expected general content of communications. Clear communication of the auditor's responsibilities, an overview of the planned scope and timing of the audit, and the expected general content of communications helps establish the basis for effective two-way communication. Matters that may also contribute to effective two-way communication include discussion of the following:

- The purpose of communications. When the purpose is clear, the auditor and those charged with governance are in a better position to have a mutual understanding of relevant issues and the expected actions arising from the communication process.
- The form in which communications will be made.
- The person(s) on the audit team and among those charged with governance who will communicate regarding particular matters.
- The auditor's expectation that communication will be two-way, and that those charged with governance will communicate with the auditor matters they consider relevant to the audit. Such matters might include strategic decisions that may significantly affect the nature, timing, and extent of audit procedures; the suspicion or the detection of fraud; or concerns about the integrity or competence of senior management.
- The process for taking action and reporting back on matters communicated by the auditor.
- The process for taking action and reporting back on matters communicated by those charged with governance.

.05 The auditor should communicate in writing with those charged with governance significant findings from the audit (see paragraphs .34–.35 of AU section 380) when, in the auditor's professional judgment, oral communication would not be adequate. This communication need not include matters that arose during the course of the audit that were communicated with those charged with governance and satisfactorily resolved. Other communications may be oral or in writing. When the auditor communicates matters in accordance with AU section 380 in writing, the auditor should indicate in the communication that it is intended solely for the information and use of those charged with governance and, if appropriate, management; and is not intended to be and should not be used by anyone other than these specified parties. When matters required to be communicated have been communicated orally, the auditor should document them. When matters have been communicated in writing, the auditor should retain a copy of the communication. Documentation of oral

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communication may include a copy of minutes prepared by the entity if those minutes are an appropriate record of the communication.

.06 The auditor should communicate with those charged with governance on a sufficiently timely basis to enable those charged with governance to take appropriate action. The appropriate timing for communications will vary with the circumstances of the engagement. Considerations include the significance and nature of the matter, and the action expected to be taken by those charged with governance.

.07 The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor should take appropriate action to address the effectiveness of the communication process.

Additional Communication Requirements

.08 Requirements for the auditor to communicate with those charged with governance are included in other standards, including the following:

a. Paragraph .17 of AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*), to communicate to those charged with governance illegal acts that come to the auditor's attention.

b. Paragraph .27 of AU section 801, *Compliance Audits* (AICPA, *Professional Standards*), to communicate to management and, if appropriate, those charged with governance the necessity of disclosure if the auditor becomes aware of noncompliance in the period subsequent to the period covered by the auditor's report and the nature of the noncompliance is of such a nature and significance that report users would be misled.

c. Paragraph .36 of AU section 801, to communicate, in the absence of a governmental audit requirement to report on internal control over compliance, in writing to management and those charged with governance, identified significant deficiencies and material weakness in internal control over compliance.

d. Paragraph .37 of AU section 801, to communicate to those charged with governance of the entity the auditor's responsibilities under GAAS, *Government Auditing Standards* and the governmental audit requirement, an overview of the planned scope and timing of the compliance audit, and significant findings from the compliance audit.

e. Paragraph .22 of AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), to inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the entity.

f. Paragraph .79 of AU section 316 to communicate with those charged with governance fraud involving senior management and fraud (whether caused by senior management or other employees) that causes a material misstatement of the financial statements. In addition, the auditor should reach an understanding with those charged with governance regarding the nature and extent of communications with those charged with governance about misappropriations perpetrated by lower level employees.

g. Paragraph .17 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*),[1] to communicate in writing to management and those charged with governance deficiencies identified during an audit that upon evaluation are considered significant deficiencies or material weaknesses, including significant deficiencies and material weaknesses that were communicated in previous audits and have not yet been remediated. See examples in the following paragraphs.

[1] See section 8300, "Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115," for further guidance.

.09 Written Communication Regarding Significant Deficiencies and Material Weaknesses Identified During an Audit of Financial Statements

[*Date of Auditor's Report on the Financial Statements*]

In planning and performing our audit of the financial statements of [*client's name*] as of and for the year ended [*financial statement date*], in accordance with auditing standards generally accepted in the United States of America, we considered [*client's name*] internal control over financial reporting *internal control* as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. Accordingly, we do not express an opinion on the effectiveness of the company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in internal control that might be significant deficiencies or material weaknesses. However, as discussed in the following sections, we identified certain deficiencies in internal control that we consider to be significant deficiencies and a deficiency that we consider to be a material weakness.

A *deficiency in internal control* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A *significant deficiency* is a deficiency, or combination of deficiencies, in internal control that is less severe than a material weakness , yet important enough to merit attention by those charged with governance. We consider the following deficiencies to be significant deficiencies in internal control.

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 recorded in a timely manner 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 him or her when they use vacation days. All employees should be required to inform the office manager of all vacation days taken. Employees should also be asked to periodically review their vacation records with the office manager and to indicate their agreement by signing the records.

Bad Debts

During 20XX, the board approved the write-off of accounts receivable of about $ [*amount*] 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 deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. We believe that the following deficiency constitutes a material weakness.

Blank Checks

Blank checks are maintained in an unlocked cabinet along with the check signing machine.

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Blank checks and the check signing machine should be locked in separate locations so as to prevent the embezzlement of funds.

This report is intended solely for the information and use of the board of directors, management, and others within the entity and is not intended to be and should not be used by anyone other than these specified parties.

Sincerely,

____

[*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 [*company's*] balance sheet dated December 31, 20X0, and the related statements of income, retained earnings, and cash flow for the year then ended. The financial statements were audited as of the financial statement date and the audit procedures performed were completed on March 28, 20X1 [*audit report date*]. No additional audit procedures were performed subsequent to March 28, 20X1.

The audit was conducted in accordance with generally accepted auditing standards (GAAS). 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, GAAS does 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 [*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 [*company's*] credit-worthiness. We recommend that you perform your own due diligence investing, 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*]

[*Name*]

[*Address*]

Dear [*Name*]:

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 20XX. We have [*number of*] partners and [*number of*] 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 [*type of*] 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 letter communicating deficiencies in internal control and a management letter communicating 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.

[*Name*], 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 $[*amount*], 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 [*number*] with questions about this proposal.

Sincerely,

____
[*Firm Signature*]

[*The next page is 8001.*]

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AAM Section 8000
Alerts

The material included in this section is intended to provide CPAs with an overview of recent economic, industry, regulatory, and professional developments that may affect audits and other engagements they perform. The material in this section has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Section Paragraph

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AAM Section 8012

General Accounting and Auditing Developments—2010/11

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Current Economic Instability: Accounting and Auditing Considerations—2009*.

This Audit Risk Alert is intended to provide auditors of financial statements with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully appreciates the invaluable assistance Keira A. Kraft provided in creating this publication.

Feedback

This Audit Risk Alert is published annually. As you encounter audit or accounting issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits and also can be used by an entity's internal management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk

that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic, Legislative, and Regulatory Developments

The Current Economy

.03 When planning and performing audit engagements, an auditor should understand both the general current economy and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

.04 The year 2010 may be the beginning of a wave of economic recovery. Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. Further, after experiencing a considerable decline in the stock market through March 2009, the markets have rebounded substantially. In March 2009, the S&P 500 and the Dow Jones Industrial Average (DJIA) reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002. By March 2010, only a year later, all 3 had increased in value by at least 59 percent from the previous year's lows. However, all 3 remained relatively unmoved 5 months later, in mid-August 2010. This exhibits the continuing uncertainty in the markets due to the varying economic indicators, the financial reform regulatory changes, and Europe's economy, among other reasons. The Chicago Board Options Exchange Volatility Index (VIX) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index options prices and is considered by many to be a barometer of investor sentiment, market volatility, and the best gauge of fear in the market. In 2008, the high closing price of VIX was 80.86; during 2009, the high closing price was 56.65—a substantial decrease from the peak of the financial crisis. Through mid-August 2010, the peak closing price for the year has been 45.79, which occurred in late May (not on the day when the DJIA inexplicably dropped nearly 1,000 points). This demonstrates the uncertainties that still plague investors.

Key Economic Indicators

.05 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States. The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.4 percent in the second quarter of 2010, 3.7 percent in the first quarter of 2010, and 5.6 percent in the fourth quarter of 2009. This data indicates a turnaround in the economy because in the fourth quarter of 2008 and the first quarter of 2009, real GDP decreased 6.3 percent and 5.5 percent, respectively. Further, in June 2010, the Treasury reported that banks had repaid about 75 percent of the bailout money they received through the Troubled Asset Relief Program and that taxpayers made $21 billion on the investment. However, other bailouts are not yet repaid, and they may yield losses to taxpayers.

.06 From July 2009 to July 2010, the unemployment rate fluctuated between 9.4 percent and 10.1 percent. An unemployment rate of 10.0 percent represents approximately 15.3 million people. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. However, through July 2010, the rate has remained below 10.0 percent. One reason for the continued high unemployment rate is that more Americans are resuming their search for work. Further, although many entities are doing better financially this year than last year, they are hesitant to hire additional workers due to uncertainties about the strength of the

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economic recovery and concerns about slipping back into a recessionary environment. Instead, those who are employed either switched from part time to full time or experienced an increase in overtime. To illustrate this trend, the Bureau of Labor Statistics reported that in May 2010, the average weekly hours and overtime of private employees had risen consistently over the last 3 months. The May 2010 average of 34.2 hours per week was last reached in January 2009. The trend in increasing current employees' hours will only meet increasing demands for a finite amount of time; plus, after working too much overtime, employees will lose efficiency. Once employers believe the recovery is sustainable and permanent, more employees will be hired.

.07 June and July 2010 exhibited some downward trends in the economy, which increased concern about the possibility of a "double-dip" recession. In each of those months, over 131,000 jobs were lost nationwide; the dip in unemployment to 9.5 percent from May was mostly attributable to a shrinking of the nation's labor force; financial activities continued to lose jobs; the median duration of unemployment remained high; and the number of buyers who signed contracts to purchase homes fell 30 percent in May. Some offsetting positive signs in June and July 2010 include the increase of jobs in the private sector, increases in manufacturing jobs, and an increase of jobs in the health care and social assistance industries. In addition, July marked the seventh month of consecutive private-sector job growth. Although, generally speaking, the overall economy is moving in the right direction, how long it will take to fully recover from the economic recession, and how bumpy that will recovery will be, remains to be seen.

.08 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent, where it remained through early August 2010. The Federal Reserve described the current economic recovery in its August 10, 2010, press release as follows:

- Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software is rising; however, investment in nonresidential structures continues to be weak, and employers remain reluctant to add to payrolls.
- Housing starts remain at a depressed level.
- Bank lending has continued to contract.
- The pace of economic recovery is likely to be more modest in the near term than had been anticipated.

.09 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant their holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the economic crisis, the Federal Reserve's balance sheet has grown to $2.3 trillion. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

Reporting Trends

Securities and Exchange Commission Comment Letters

.10 As discussed in the May 2010 issue of *CFO* magazine, a list of the top 10 concerns of the Securities and Exchange Commission (SEC) related to U.S. entities' annual and quarterly filings dated between January 1, 2009, and January 1, 2010, was compiled. The data was based upon a comment letter database, as of March 24, 2010, compiled by the research firm Audit Analytics. In general, the topics commented on by the SEC remain consistent over the years. The most commented area in filings is the "Management's Discussion & Analysis (MD&A)" section, which provides an overview of the period's operations, how the entity performed, and management's approach to the coming year. It also discusses the fundamentals of the entity, which include members of management and their management style. Typically, the SEC requests more details in entities' descriptions of their operating results, their liquidity and capital resources, and how they develop critical accounting estimates. The next two most commented areas include executive compensation and fair

value measurements, which given the economic climate, is not unexpected. The SEC also continues to remain interested in incentive-pay performance targets, such as earnings per share. The remaining seven top concerns of the SEC are intangible assets and goodwill; disclosure controls; segment reporting; non-generally accepted accounting principles (GAAP) measures, revenue recognition; debt, warrants, and equity issues; and related-party transactions. These general areas of focus in the financial statements should be considered by all preparers and auditors in order to provide investors and regulators with the most useful and transparent financial information.

Loss Contingency Disclosures

.11 The SEC also focuses on the adequacy of loss contingency disclosures in the financial statements of registrants, particularly regarding litigation. The SEC staff has expressed concern about the lack of timely and transparent disclosures. Further, registrants sometimes fail to disclose the amount or range of possible loss when no amount is accrued because the loss is only reasonably possible (rather than probable). Disclosures on contingencies should be specific rather than generic. Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450-20-50 discusses disclosures for loss contingencies and explains that in some circumstances, it may be misleading not to disclose the amount accrued in the financial statements for a loss contingency. If an exposure to loss exists in excess of amounts accrued and it is reasonably possible that a loss or additional loss may have been incurred, the estimated possible loss or range of loss or a statement that such estimate cannot be made should be included in the disclosures. The SEC also questioned the following inconsistency: registrants disclose in the footnotes that the outcome of a contingency is not expected to materially affect their financial statements but explain in the "Risk Factors" section that the same contingency's outcome could materially affect their financial results.

.12 Discussion from the SEC about contingencies can be found in the Division of Corporate Finance's *Current Accounting and Disclosures Issues in the Division of Corporate Finance*, which can be accessed at www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf. FASB also has a project on its agenda to revise the guidance on disclosure of certain loss contingencies, which is discussed in further detail in the "On the Horizon" section of this alert.

Going Concern

.13 The percentage of audit reports for 2009 containing a going concern qualification is substantially unchanged from the percentage in 2008, according to Audit Analytics and based on fiscal year 2009 SEC filings through the end of April 2010. In 2008, an extremely challenging economic year, approximately 20.3 percent of audit reports had a going concern qualification. Although 2009 was certainly not a year of economic boom, GDP did turn positive by the third quarter and continued on that trend. However, the percentage of going concern qualification reports for 2009 remained high at 19.8 percent. Although this is a slight decrease, the explanation for the decrease appears to be unrelated to the current economic recovery. Instead, it may be attributable to 8.4 percent of the going concern entities from 2008 deregistering with the SEC in 2009; the SEC is estimated to receive 518 fewer audit opinions for 2009 than 2008. In 2009, the most common reason for auditors' concern over their clients' futures and, therefore, a going concern opinion was net operating loss. When examining going concern opinions since 2000, 2003 and 2004 produced the lowest amount and 2007 produced the highest amount; in 2007, there was a 28 percent increase from the number of going concern opinions issued in both 2003 and 2004. It remains to be seen how the uncertain economic conditions of 2010 will affect entities and their futures and whether going concern opinions will remain high or decrease from a continued economic recovery.

SEC Circuit Breaker Rules

.14 On May 6, 2010, a market disruption occurred whereby the DJIA rapidly fell almost 1,000 points. The reasons for the fall have yet to be confirmed and are thought to have occurred due to a system glitch. Approximately 1 month later, the SEC approved rules that will require the exchanges and the Financial Industry Regulatory Authority to pause trading in certain individual stocks if the price moves 10 percent or more in either direction in a 5 minute period. The pause would only apply to stocks in the S&P 500 and would

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give the markets the opportunity to attract new trading interest in an affected stock, establish a reasonable market price, and resume trading in a fair and orderly fashion. These rules are in effect on a pilot basis through December 10, 2010. The pilot period will be used to make appropriate adjustments to the parameters or operations of the circuit breakers based on the experience, and the scope of the rules will be expanded to securities beyond the S&P 500 as soon as practicable. Additionally, the SEC is considering recalibrating marketwide circuit breaker rules that were already in effect in May 2010 but were not triggered during the May 6 minicrash. By the end of June, these circuit breakers had been set off twice—both times for erroneous trades.

Legislative and Regulatory Developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.15 On July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law in response to weaknesses in the financial services industry that are believed to have contributed to the recent economic recession. The Dodd-Frank Act was approved by the House on June 30, before narrowly clearing the Senate on July 15. As the economy is slowly recovering from the worst economic downturn since the Great Depression, this reform represents the greatest change to financial regulation since that time. It ends the era of hands-off regulation and increased deregulation of the financial services industry. The two main goals of the reform are to lower the systemic risks to the financial system and enhance consumer protections.

.16 The Dodd-Frank Act, among many other changes, will create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisers. It mandates over 60 different studies and reports by various oversight agencies on a range of issues. Because these new regulations will most likely be produced over the next few years, the timing of the impact of these reforms will be staggered. This will provide opportunities for the financial services industry to respond to the proposed regulations and work with regulators in developing reporting requirements, formats, and timetables that are practical to implement. Additionally, this will enable both regulators and the industry to meet their individual goals, which is important to the efforts to avoid market disruptions and inadvertently increase systemic risk. Large, complex institutions, in particular, and newly regulated entities with new reporting requirements will be challenged to update their systems and data infrastructures. Although the Dodd-Frank Act contains many provisions, some highlights that may be of particular interest to auditors are summarized in the following sections.

Financial Stability Oversight Council

.17 The Dodd-Frank Act creates a new systemic risk regulator called the Financial Stability Oversight Council (FSOC), which is to be led by the Treasury secretary. The two main goals of the FSOC are to identify risks to the financial stability of the United States and promote market discipline by eliminating the expectation of "too big to fail." To meet these goals, the FSOC has many powers, and it will identify any company, product, or activity that could threaten the financial system. The FSOC has the power to designate nonbank financial entities as systemically important and, through the Office of Financial Research (OFR), may collect reports from any bank holding entity or nonbank financial entity for the purpose of determining whether it poses a threat to U.S. financial stability. The new OFR is targeted to be established and fully operational no later than one year after enactment. The FSOC will be chaired by the Treasury secretary, and members will be heads of regulatory agencies, including the chairmen of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the SEC, among others. The first meeting of the FSOC will be in October 2010. For those large entities deemed a threat to the U.S. financial system, the FSOC can, under the authority of a new orderly liquidation authority, authorize the FDIC to close such entities under the supervision of the Federal Reserve. Upon enactment of the Dodd-Frank Act, the FSOC, through the Federal Reserve, will also have the power to preemptively require a large, complex entity to divest some of its holdings if it poses a grave threat to the stability of the United States, although this is intended only as a last resort.

.18 The FSOC will make recommendations to the Federal Reserve to increase capital, leverage, liquidity, risk management, and other requirements as entities grow in size and complexity, with significant requirements for entities that pose a risk to the financial system. Final rules must be made by the Federal Reserve no later than 18 months after enactment. The current level of minimum leverage capital requirements is to be the floor for the future capital requirements to be developed. New and stricter capital requirements will have differing effects on financial entities: some may move toward lower-margin businesses that are less capital intensive but others may continue to strive for higher returns. Further, new forms of capital may be considered a possibility, such as contingent capital. This capital would effectively be subordinated, and other forms of debt that convert to common equity under prescribed conditions may be considered. Low interest rates and government support have helped many entities build up their capital. Some rating agencies have said that without this assistance, many entities would have lower credit ratings, and as the new rules are implemented, some may experience downgrades. Entities will likely be considering new ways to build and maintain capital or shed troubled assets. The FSOC has the ability to veto rules created by another new regulator, the Bureau of Consumer Financial Protection, with a two-thirds vote.

.19 The FSOC also has monitoring and reporting responsibilities. It will review and, as appropriate, submit comments to the SEC and any other standard setting body (for example, FASB) with respect to an existing or proposed accounting rule. Further, the FSOC must annually report to Congress significant financial market and regulatory developments, including accounting and insurance regulations, along with assessing their possible impact on the financial system's stability. Lastly, it will make recommendations on implementation of the Volcker Rule to aid regulators. These recommendations must be issued no later than six months after enactment, with final rulemaking no later than nine months after the FSOC's recommendations.

Bureau of Consumer Financial Protection

.20 The Bureau of Consumer Financial Protection (BCFP) is the new independent watchdog (although it will be housed at the Federal Reserve), and it consolidates most federal regulation of financial services offered to consumers. The BCFP will ensure consumers obtain clear, accurate information to shop for mortgages, credit cards, and other financial products (but not products subject to securities or insurance regulations); provide them with one powerful and dedicated advocate; and protect them from hidden fees and deceptive practices. The BCFP will also oversee the enforcement of federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for individuals and communities. The director of the BCFP replaces the director of the Office of Thrift Supervision (OTS) on the FDIC board (the OTS was abolished by the Dodd-Frank Act). The BCFP will be led by an independent director appointed by the president and confirmed by the Senate, with a dedicated budget in the Federal Reserve. Functions currently handled by existing agencies are expected to be transferred to the BCFP, and the BCFP is expected to assume full authority for consumer financial protection no later than one year after enactment.

.21 A significant mortgage reform provision of the Dodd-Frank Act is the creation of a new federal standard applicable to home loans that requires institutions to ensure borrowers can repay the loans they were sold. Lenders and mortgage brokers who do not comply with the new rules prohibiting unfair lending practices will be held accountable through imposed penalties. The mortgage reforms from the Dodd-Frank Act are effective immediately. The Dodd-Frank Act does not address the government-sponsored entities Fannie Mae and Freddie Mac—they will be addressed separately through future legislation.

.22 The BCFP has the authority to examine and enforce regulations for banks and credit unions with assets of over $10 billion and all mortgage-related businesses (lenders, servicers, mortgage brokers, and foreclosure scam operators); providers of payday loans; and student lenders, as well as other nonbank financial entities that are large, such as debt collectors and consumer reporting agencies. Banks and credit unions with assets of $10 billion or less will be examined for consumer complaints by the appropriate regulator. The BCFP also is able to autonomously write rules for consumer protections governing all financial institutions (banks and nonbanks) offering consumer financial services or products. The Dodd-Frank Act recognizes that CPAs providing customary and usual accounting activities (which include accounting, tax, advisory, or other services that are subject to the regulatory authority of a state board of accountancy) and other services

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incidental to such customary and usual accounting activities are already adequately regulated and, therefore, are not subject to the BCFP's authority.

.23 A national consumer complaint hotline will be created so consumers will have, for the first time, a single toll-free number to report problems with financial products and services.

Financial Planning Study

.24 The Government Accountability Office (GAO) is required to study the effectiveness of regulatory oversight of financial planners and make recommendations on how financial planning should be regulated.

Section 404(b) SOX Exemption

.25 The Dodd-Frank Act amends SOX to make permanent the exemption from its Section 404(b) requirement for nonaccelerated filers (those with less than $75 million in market capitalization) that had temporarily been in effect by order of the SEC. Section 404(b) of SOX requires companies to obtain an auditor's report on management's assessment of the effectiveness of the company's internal control over financial reporting. It is important to note that Section 404(a) of SOX, which requires management's attestation on internal control over financial reporting, is still required for nonaccelerated filers. The Dodd-Frank Act also requires the SEC to complete a study within 9 months of the act's enactment on how to reduce the burden of Section 404(b) SOX compliance for companies with market capitalizations between $75 million and $250 million. The study will consider whether any such methods of reducing the burden, or a complete exemption, would encourage companies to list on U.S. exchanges.

.26 Another study required by the Dodd-Frank Act is for the GAO to evaluate whether issuers that are exempt from Section 404(b) requirements have fewer or more restatements than those that are required to comply, how the cost of capital compares for exempt issuers, whether any difference exists in investor confidence in the integrity of the financial statements of exempt versus complying issuers, and whether exempted entities should be required to disclose to investors the absence of Section 404(b) attestation and the costs and benefits of voluntary compliance. The report of findings from the second study is due to Congress within three years.

The PCAOB

.27 The Dodd-Frank Act also provides for the PCAOB to create a program for registering and inspecting the auditors of broker-dealers, including standard setting and enforcement. Currently, all auditors of broker-dealers must be registered with the PCAOB. Covered auditors will now be required to follow PCAOB guidance, although the Dodd-Frank Act allows the PCAOB, in its inspection rule, to differentiate among broker-dealer classes and to potentially exempt introducing brokers, such as those who do not engage in clearing, carrying, or custody of client assets.

.28 The PCAOB is also now authorized, in certain circumstances, to share information with foreign audit oversight authorities. This will facilitate PCAOB cooperation with its foreign counterparts and PCAOB inspection of non-U.S. firms. When SOX was enacted, few other countries had similar audit oversight bodies, and therefore, no provisions in SOX existed to authorize sharing information with foreign authorities. Since then, many countries have established, or are in the process of establishing, similar audit oversight bodies.

.29 Further, any registered public accounting firm (domestic or foreign) that relies, in whole or in part, on the work of a foreign public accounting firm in issuing an audit report, performing audit work, or conducting an interim review must (*a*) produce the foreign firm's audit work papers and all related documents if the SEC or PCAOB requests them and (*b*) secure the foreign firm's agreement to produce those documents as a condition of relying on the work of that firm. Any foreign firm that performs work for a domestic registered public accounting firm must provide the domestic firm with written consent and power of attorney designating the domestic firm as an agent on whom the SEC or PCAOB may serve a request for documents. Any foreign firm that performs material services on which a registered public accounting firm relies must

designate to the SEC or PCAOB an agent in the United States on whom the SEC or PCAOB may serve a request for documents. The SEC or PCAOB may allow a foreign firm to meet document production obligations through alternate means, such as through the SEC's or PCAOB's foreign counterparts.

Derivatives Trading

.30 The Dodd-Frank Act provides the SEC and the Commodity Futures Trading Commission (CFTC) with the authority to regulate over-the-counter (OTC) derivatives and requires central clearing and exchange trading for derivatives that can be cleared. The SEC will have authority over security-based swaps (including credit default swaps). The CFTC will have authority over all other swaps, including energy-rate swaps, interest-rate swaps, security-based swap agreements, and broad-based security group or index swaps. Standardized swaps will be traded on an exchange or in other centralized trading facilities, which will promote transparency; standardized derivatives will also have to be handled by central clearinghouses. *Cleared* describes when trades are routed through a central clearinghouse that covers losses if a party to the trade is unable to complete the transaction. As a safeguard, many derivative traders will also be required to post margin to ensure all obligations can be paid and to offset the general risks that derivative trading poses to the financial system. Clearing and exchange trading requirements are expected to become effective 360 days following enactment.

.31 The Dodd-Frank Act also provides regulators with the authority to impose capital and margin requirements on swap dealers and major swap participants, not end users. Rules prescribed by the CFTC or the SEC must be promulgated no later than 360 days after enactment. By making the market more transparent, the pricing of common kinds of derivatives from the open marketplace may be reduced and would allow a wider range of entities to hedge their risks; customized derivatives could still have higher prices. The credit exposure from derivative transactions will be added to banks' lending limits. However, the new rules may increase some costs of derivative trading because with the increase in transparency and price competition between securities dealers, the dealers will face decreased profit margins and may charge a higher trading fee. Banks are allowed to continue engaging in principal transactions involving interest-rate, foreign-exchange, gold, silver, and investment-grade credit default swaps, subject to Volcker Rule limitations on proprietary trading. For commodities, most other metals, energy, and equities, banks will have to shift their swap operations to a separately capitalized affiliate within the holding entity. Under an end user exemption, nonfinancial firms can still use derivatives to hedge and manage the commercial risks associated with their business.

Registered Investment Advisers and Hedge Funds

.32 The Dodd-Frank Act will require advisers to hedge funds and private equity funds with over $150 million in assets to register with the SEC and be subject to its oversight. Venture capital funds and family offices will be exempt from registration with the SEC. The new registration requirement will become effective 1 year after enactment; however, any investment adviser may, at the discretion of the investment adviser, register with the SEC during that 1-year period. This new requirement may cause smaller funds to incur greater costs and possibly force some of them to close or raise fees to investors. Currently, the Investment Advisers Act of 1940 requires investment advisers with over $30 million in assets under management to register with the SEC. Under the new reform, this threshold for federal regulation will be raised to $100 million, with certain exceptions. This change will increase the number of small advisers under state supervision and allow the SEC to focus on newly registered hedge funds. Advisers will provide information about their trades and portfolios necessary to assess their systemic risk. The exemption in the Investment Advisers Act of 1940 for advisers with fewer than 15 clients has also been eliminated.

.33 Investment advisers, now including hedge funds, must take steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the commission may, by rule, prescribe. The Dodd-Frank Act also raises the standard for individuals to qualify as accredited investors, a basic threshold for purchasing private investments; these investors must now have $1 million, excluding the value of their primary residence. The prior standard was simply $1 million.

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SEC and Investor Protections

.34 Because it lowers the legal standard from "knowing" to "knowing or reckless," the Dodd-Frank Act may make it easier for the SEC to prosecute aiders and abettors of those who commit securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. This change will increase the difficulty for a defendant to fight a civil enforcement action because the SEC does not have to show that the person intended to aid another person's violation but only that reckless conduct furthered the violation. The SEC and the Department of Justice will also now have the authority to bring civil or criminal law enforcement proceedings involving transnational or extraterritorial securities frauds. Additionally, the Dodd-Frank Act authorizes 2 studies on these matters. One of the studies directs the GAO to investigate the impact of authorizing private rights of action for aiding and abetting claims and to release its findings within 1 year. The second study directs the SEC to examine whether private rights of action should be authorized for transnational or extraterritorial claims, and that study is to be completed within 18 months.

.35 The Dodd-Frank Act gives the SEC the authority to impose a fiduciary duty on brokers who give investment advice (that is, the advice must be in the best interest of their customers—currently, this applies to investment advisers). Currently, brokers are only required to recommend investments that are suitable for customers. The SEC must first study this issue and deliver a report to Congress on the costs and benefits. The Office of the Investor Advocate (OIA) will also be created within the SEC to identify areas where investors have significant problems dealing with the SEC and to provide them with assistance. Another responsibility of this office will be to identify areas in which investors would benefit from changes in the regulations of the SEC. The OIA must submit its first annual report to Congress no later than June 30, 2011.

.36 A whistle-blower program, with rewards to encourage securities violations reports, was created by the Dodd-Frank Act. An exception is provided for any whistle-blower who gains information through the performance of an audit of financial statements. Employers are prohibited from retaliating against whistle-blowers. Subsidiaries and affiliates that are consolidated with public companies for financial accounting purposes will become subject to the whistle-blower protections in SOX.

.37 The SEC is permitted to use fee collections to establish a reserve fund of up to $100 million, which can be used to fund special projects. The SEC may submit its annual budget directly to Congress without requiring the prior approval of the White House. The SEC has publicly stated that it will need to hire approximately 800 new people to carry out the new reforms (given the new required enforcement, the 5 offices created within the SEC, and the studies to be carried out) and to develop the specifics of new regulations.

Executive Compensation

.38 The Dodd-Frank Act requires a nonbinding shareholder vote on executive pay and golden parachutes. This is intended to give them the power to hold executives accountable. Although the vote is nonbinding, a "No" vote by shareholders would likely force management to respond in some way and can still have a beneficial effect. At a public company's first shareholder meeting following the end of the six month period after enactment, management must give shareholders the opportunity to vote on how frequently shareholders will have a "say on pay" (that is, annually, every two years, or every three years). The SEC now has the authority to grant shareholders proxy access to nominate directors, which is intended to help shift management's focus from short-term profits to long-term growth and stability. However, shareholders would need to exercise this right for it to have any possibility of an impact. The SEC is allowed to exempt small businesses from this requirement. The SEC issued a proposed proxy access rule last year but has been waiting for the clear legal authority that this act provides prior to moving ahead with a final rule. The SEC is already in the process of drafting proxy access rules for public comment. The Dodd-Frank Act also requires entities to disclose in their annual proxy statement the median of annual total compensation to all employees, other than their CEO; the annual total compensation of the CEO; and the ratio of these two amounts. Disclosure is also required on why the chairman of the board and CEO positions are separate or combined.

.39 Compensation based on financial statements that are restated must be returned for the 3 years preceding the restatement in an amount equal to the excess of what would have been paid under the restated results. This is required regardless of whether the executive was involved in the misconduct that led to the restatement. Listing exchanges will enforce the compensation policies. The Dodd-Frank Act also requires directors of compensation committees to be independent of the entity (*independent* as defined by its exchange) and its management. The members of that committee are required to select consultants, legal counsel, and other advisers only after taking into account independence factors established by the SEC. The SEC will write these rules, and these final rules are required not later than 360 days after enactment. New disclosures regarding compensation will also be required, such as the incentive-based compensation policies. Further, the SEC is required to clarify disclosures on compensation, including requirements to provide information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.

.40 Overall, the level and complexity of the relationships that entities have with their regulators will increase because of the passage of the Dodd-Frank Act. Already, many firms have chief risk officers who sit above any risk management structures inside business units and try to manage the firm's overall risk profile. This position is important because it creates a single senior point of contact for regulators seeking a high-level understanding of where a firm may have risk concentrations with possible systemic implications. Entities that don't have this position will likely reconsider the creation of one.

Ending "Too Big to Fail" Bailouts

.41 The Dodd-Frank Act is intended to reduce the risk that large firms will take excessive risk because they believe they are, in effect, guaranteed to be bailed out in the event of failure. Bailouts like this occurred during the recent economic recession. Although that is an intent of the specific changes required by this reform, whether that goal will be achieved can only be determined over time. The goal is that taxpayers will not again be responsible to save a failing financial entity or cover the cost of its liquidation.

.42 Under the new Volcker Rule of the Dodd-Frank Act, a banking entity will now be prohibited from proprietary trading; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or private equity fund. Final rulemaking on the Volcker Act must be no later than nine months after the FSOC's recommendations on implementation considerations. *Proprietary trading* consists of transactions made by an entity that affect the entity's own account but not the accounts of its clients; the entity is using its own money to place directional market bets that are unrelated to serving customers. Some of the benefits to bank entities of proprietary trading, which will now be eliminated, include the following:

- Allows the entity to profit on its own instead of collecting commissions and fees from clients
- Allows the entity build an inventory of securities, which can be useful if a client places a trade in an illiquid market
- Allows the bank to make a market when it is assigned to ensure the liquidity for a given security

.43 A major bank estimated that 10 percent of its revenue came from proprietary trading, but that may vary depending on the size and complexity of the institution. Banks are allowed to make de minimis investments in hedge funds and private equity funds, using no more than 3 percent of their tangible common equity in all such funds combined. Also, a bank's investment in a private fund may not exceed 3 percent of the fund's total ownership interest. Nonbank financial institutions supervised by the Federal Reserve will also have restrictions on proprietary trading, hedge fund investments, and private equity investments.

.44 The Dodd-Frank Act also requires large, complex financial entities to periodically submit plans for their rapid and orderly shutdown should the company go under (a "funeral plan" or "living will"). No later than 18 months after enactment, the Federal Reserve Board and the FDIC must issue final rules implementing the resolution plan requirement. Entities that fail to submit acceptable plans will have higher capital requirements and restrictions on growth and activity, as well as divestment. This will create an increased focus on entity-level financial and operational concerns for these large, complex entities.

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.45 Additionally, an orderly liquidation mechanism for the FDIC to unwind failing systemically significant financial entities that pose a risk to the financial system has been created. The mechanism provides that shareholders and unsecured creditors bear losses and management and culpable directors will be removed. The FDIC will only be allowed to borrow funds to liquidate an entity when it expects to be repaid from the assets of the entity being liquidated, and the government will be first in line for repayment. Funds that are not repaid from the sales of the entity's assets will be repaid first through the clawback of any payments to creditors that exceeded liquidation value and then through assessments on large financial entities (with the riskiest ones paying more). Taxpayers will bear no cost for liquidations, and the bailout of an individual entity will become prohibited by the Federal Reserve. To prevent bank runs, the FDIC can guarantee debt of solvent insured banks, but only after meeting serious requirements.

Other Bank and Thrift Regulations

.46 The Dodd-Frank Act abolishes the OTS and transfers authority mainly to the Office of the Comptroller of the Currency, which also regulates federally chartered national banks. However, the thrift charter has been preserved. There will be a permanent increase in deposit insurance for banks, thrifts, and credit unions to $250,000, which is retroactive to January 1, 2008. Cash limits on Securities Investor Protection Corporation protection is also increased from $100,000 to $250,000, subject to periodic adjustments for inflation. The prohibition of banks paying interest on demand deposits has been repealed. Additionally, the Dodd-Frank Act removes a regulatory arbitrage opportunity by prohibiting a bank from converting its charter (unless both the old and new regulator do not object) in order to avoid an enforcement action.

Rating Agencies

.47 Rating agencies became subject to increased scrutiny, given their role in the subprime mortgage crisis. The Dodd-Frank Act creates an Office of Credit Ratings at the SEC that must examine credit ratings agencies at least once per year and make key findings public. These agencies will now be subject to expert liability with the nullification of Rule 436(g), which had provided an exemption for credit ratings provided by credit rating agencies from being considered a part of the registration statement. In order to include a credit rating agency's rating in a registration statement, the registrant must file the credit rating agency's consent along with the registration statement. This will make credit rating agencies vulnerable to lawsuits when underwriters include their assessments in documents used to sell debt; they will now face the same legal risks as accountants and other parties who participate in bond sales. Investors can now bring private rights of action against ratings agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source. The SEC also has the authority to deregister a credit rating agency for providing bad ratings over time. The SEC will be required to investigate any conflicts of interest involved in financial entities picking the agency they believe will give them the highest ratings. Credit rating agencies will be required to disclose their methodology and track record. The SEC will conduct a study on the feasibility of a public or private entity that would be responsible for the assignment of a credit rating to the credit rating agencies.

.48 New rules were also made to help ensure the objectivity and independence of the employees of credit rating agencies. These agencies must conduct a 1-year lookback review when an employee goes to work for an obligor or underwriter of a security or money market instrument subject to rating by that credit rating agency. A report to the SEC is also required when certain employees of a credit rating agency go to work for an entity that the agency has rated in the previous 12 months. Ratings analysts will also be required to pass qualifying exams and take continuing education.

Other Requirements and Additional Information

.49 The Dodd-Frank Act also makes changes to securitization rules. Entities that sell products such as mortgage-backed securities will now be required to retain at least 5 percent of the credit risk, unless the underlying loans meet standards that reduce risk. The federal banking agencies must prescribe final rules for credit risk retention no later than 270 days after enactment. Issuers of these securities will also be required to disclose more information about the underlying assets, including analysis of the quality of the underlying

assets. A study is mandated regarding the impacts of the new credit risk retention requirements and FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, and No. 167, *Amendments to FASB Interpretation No. 46(R)*, on asset-backed securities.

.50 The first ever office in the federal government focused on insurance will be created, which will monitor the insurance industry for systemic risk purposes, among its other responsibilities.

.51 The impact of these new reforms on the capital markets and credit availability is difficult to predict. Although strengthening transparency is an appropriate response to the recent economic recession, the more stringent rules may affect economic recovery. Additionally, with the new capital requirements, regulators are likely to disapprove of any perceived efforts by entities to avoid compliance, and those firms that do so may risk political backlash and reputational harm. A copy of the full Dodd-Frank Act, as signed by the president, can be found at www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/ BILLS-111hr4173ENR.pdf. The AICPA is also following any developments related to the Dodd-Frank Act on our website at www.aicpa.org under "Advocacy—Federal Issues."

The Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act

.52 In March 2010, the president signed into law a sweeping overhaul of the health care system. Almost everyone in the United States will be affected by these changes—individuals, insurance companies, health care providers, and employers. The three primary goals of the reform are to expand coverage to those without health insurance, reform the delivery system of benefits to improve quality, and decrease the costs of providing health care. The various provisions of the reform will become effective over time, through 2020. The new laws contain many changes for employers to consider for financial reporting purposes, in addition to many new tax rules to help offset the overall cost of the reform.

.53 The complete changes are contained in two acts. The Health Care and Education Reconciliation Act of 2010 was signed on March 30 and is a reconciliation bill that amends the Patient Protection and Affordable Care Act signed into law by the president one week earlier. In April, the SEC issued a staff announcement, *Accounting for the Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act*, to address questions that have arisen about the effect, if any, that the different signing dates might have on accounting for the two acts. This timing difference, related solely to the signing dates, should not have an impact on a majority of registrants because the acts were both signed within a relatively short time period, which for the vast majority of entities, falls into the same reporting period. However, there may be a limited number of registrants with a period-end that falls between the signing dates for which the timing difference could raise questions about whether the different signing dates have an accounting impact.

.54 After consultation with the FASB staff, the Office of the Chief Accountant would not object to a view that the two acts should be considered together for accounting purposes. That is, in this specific fact pattern, the SEC staff would not object to a registrant incorporating the effects of the Health Care and Education Reconciliation Act of 2010 when accounting for the Patient Protection and Affordable Care Act. This view is based in part on the SEC staff's understanding that the two acts, when taken together, represent the current health care reform as passed by Congress and signed by the president. The SEC staff does not believe that it would be appropriate to analogize to this view in any other fact patterns.

Significant Accounting and Tax Considerations

.55 As background, FASB ASC 740-10-30-2 states that the following basic requirements are applied to the measurement of current and deferred income taxes at the date of the financial statements:

- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

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.56 FASB ASC 715-60-35-102 further explains that benefit coverage for medical claims by governmental programs or other providers of health care benefits should be assumed to continue as provided by the present law and other providers, pursuant to their present plans. Consistent with FASB ASC guidance, presently enacted changes in the law or amendments of the plans of other health care providers that take effect in future periods and that will affect the future level of their benefit coverage should be considered in current period measurements for benefits expected to be provided in those future periods. Future changes in laws concerning medical costs covered by governmental programs and future changes in the plans of other providers should not be anticipated.

.57 The two primary accounting considerations resulting from this reform are the effects of the tax law changes on deferred income tax balances and other postretirement health benefits. One of the most significant changes relates to the government subsidy for providing qualifying prescription drug coverage to Medicare-eligible retirees becoming an offset for prescription drug income tax deductions. Specifically, because entities will need to reduce their income tax deduction for providing prescription drug coverage by the subsidy received, they currently need to record a charge to earnings to write off a portion of their deferred tax assets related to postretirement health care obligations. Such deferred tax assets were based on the gross liability amount. Because the tax deductible prescription drug costs liability will be reduced by the subsidy, the deferred tax asset will be computed net of the subsidy, resulting in a lower deferred tax asset. The federal subsidy will not reduce the tax deductions until 2013. Even though the changes may not be effective until future periods, the effects are accounted for in the period that includes the enactment date. FASB ASC 715-60 discusses accounting and reporting guidance for other postretirement plans, including the Medicare prescription drug plan. Many public entities have already posted large noncash charges in early 2010 related to the nondeductibility of the subsidy.

.58 Some of the other provisions of the reform that may affect an entity's tax position include the nondeductible pharmaceuticals fee, the medical device excise tax, and the therapeutic discovery project tax credit, which will have an effect on the pharmaceutical and medical device industries. Additionally, employer group health plans may not impose lifetime limits and can only impose "restricted" annual limits beginning with the 2011 plan year (for calendar year plans); no annual limits would be permitted beginning in 2014. Because these health benefits can no longer be limited, entities may need to increase accruals for future medical obligations. Many small businesses and tax-exempt organizations that provide health insurance coverage to their employees will now qualify for a special tax credit that is designed to encourage small employers to offer health care coverage for the first time or maintain the coverage they have.

.59 Lastly, under the new reform, a 40 percent penalty will apply to tax understatements attributable to transactions lacking economic substance (20 percent with adequate disclosure) or failing to meet the requirements of any similar rule of law. A transaction is treated as having economic substance only if the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

.60 The full text of these acts can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ152.111.pdf and http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ148.111.pdf. Readers are also encouraged to refer to the Audit Risk Alerts *Health Care Entities—2010/11* (product no. 0223410) and *Not-for-Profit Entities—2010* (product no. 0224210).

PCAOB Constitutionality

.61 On June 28, 2010, the Supreme Court ruled in the lawsuit challenging the constitutionality of the PCAOB. When the PCAOB was set up under SOX, its board members were appointed by the SEC and could be removed only for cause. The Supreme Court ruled, in a 5-4 vote, that although the manner in which the PCAOB was constituted was constitutionally invalid, SOX itself was not invalidated. Rather, the Supreme Court severed from the rest of SOX the provisions relating to the removal of PCAOB board members. The consequence of the Supreme Court's decision is that PCAOB board members will now be removable by the SEC at will, instead of only for good cause. Essentially, this decision has no material impact on the workings of the PCAOB, and all PCAOB programs will continue to operate as usual, including registration, enforcement, and standard-setting activities.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.62 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some risks that may affect an entity in the current economic environment are as follows:

- Marginally achieving explicitly stated strategic objectives
- Volatile real estate and business markets
- Significant measurement uncertainty, including accounting estimates and fair value measurements
- Potentially erroneous or fraudulent activity due to decreased staffing and resurgence of business activity
- The continuing evolution of the postrecessionary marketplace

.63 Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

Enterprise Risk Management

.64 To meet the challenges and risks in today's business and economic environment, many entities have turned to enterprise risk management (ERM). Further, the recent economic crisis has led to a renewed focus on how senior executives approach risk management and the role of their boards of directors in risk oversight. The purpose of ERM is to address processes, procedures, and risk on an entity-wide basis to enable management to holistically understand the business risks that the entity faces. Some characteristics of the ERM model include strengthening communication; additional training, including cross-training, process, and internal control improvement; and entity-wide participation.

.65 Once implemented, managers of individual business components can make appropriate decisions based on an understanding of the risks that each business component encounters and how those risks affect other components and the entity as a whole. The purpose of this process is not to reduce business risk but rather to provide the knowledge that management needs to effectively assess risks and to then plan appropriate strategies to achieve the entity's business objectives. A good ERM framework allows the entity to foresee potential consequences from future events, make necessary changes to minimize risk, manage the negative fallout if an event materializes, and capitalize on the opportunities that it presents for growth.

.66 ERM can help an entity articulate its major risks and identify the nature of those risks, then develop a process for measuring, monitoring, and controlling these risks. ERM can help shape the commentary in MD&A, but not all ERM-related information will be relevant and important enough to warrant mention in the MD&A. The presence and use of an ERM system is something that many entities include in the MD&A section of their financial statements. This provides investors, analysts, and rating agencies with a better picture and more insight into the goals of the entity.

.67 A strong ERM, or the lack thereof, is an important consideration for an external auditor when understanding and assessing the entity's environment, internal control, and corporate governance, in addition to the overall audit risk. Further, the risk-based approach of current auditing has nurtured the concept of an effective financial statement audit being intertwined with business risks and, therefore, ERM. Business risks of any nature ultimately affect the risk of misstatement in the financial statements. In many entities, an internal

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auditor conducts an audit on the effectiveness of the framework by examining that the risk management practices defined in the framework are in use and operating as expected. In all entities, management is the owner of the ERM framework and surrounding processes.

.68 Additional information about ERM can be obtained from the Committee of Sponsoring Organizations of the Treadway Commission (COSO's) website at www.coso.org.

.69 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

PCAOB Auditing Standards on Risk Assessment

.70 In August 2010, the PCAOB adopted a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit. These standards were initially proposed in late 2008 and reproposed in late 2009. These risk assessment standards will benefit investors by setting forth requirements that enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. They are applicable to audit procedures spanning from the initial planning stages of the audit to the evaluation of the audit results. Improvements in the risk assessment standards should enhance integration of the audit of financial statements with the audit of internal control over financial reporting by articulating a process for identifying and assessing risks of material misstatements that apply to both portions of the integrated audit.

.71 The new auditing standards, with a brief description of each, are as follows:

- Auditing Standard No. 8, *Audit Risk*, discusses the auditor's consideration of audit risk in both an integrated audit and an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing it to an appropriately low level.
- Auditing Standard No. 9, *Audit Planning*, establishes requirements for planning an audit, such as assessing important matters and establishing an appropriate audit strategy.
- Auditing Standard No. 10, *Supervision of the Audit Engagement*, is applicable to the engagement partner and other team members who supervise during the audit. It sets forth requirements for supervision of the audit engagement and the work of other engagement members. Related to this topic, the PCAOB also recently issued a release discussing the provision of SOX that authorizes the PCAOB to impose sanctions on registered public accounting firms and their supervisory personnel for failing to reasonably supervise associated persons.
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements for auditors in identifying and assessing risks of material misstatement, including information-gathering procedures.
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements for responding to those identified risks of material misstatement through general audit procedures. It also includes audit procedures related to significant accounts and disclosures.
- Auditing Standard No. 14, *Evaluating Audit Results*, establishes requirements for evaluating audit results and the sufficiency of appropriate audit evidence.
- Auditing Standard No. 15, *Audit Evidence*, discusses what constitutes audit evidence and how to design and perform audit procedures to support the opinion expressed in the auditor's report.

.72 These risk assessment standards will supersede the following six PCAOB interim standards and related amendments: AU section 311, *Planning and Supervision*; AU section 312, *Audit Risk and Materiality in Conducting an Audit*; AU section 313, *Substantive Tests Prior to the Balance Sheet Date*; AU section 319, *Consideration of Internal*

Control in a Financial Statement Audit; AU section 326, *Evidential Matter*; and AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). The standards, if approved by the SEC, will be effective for audits of fiscal periods beginning on or after December 15, 2010.

Engagement Quality Review for Issuers

.73 In January 2010, the PCAOB announced that the SEC had approved Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which was adopted by the PCAOB in July 2009. Auditing Standard No. 7 provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. Auditing Standard No. 7 is expected to increase the likelihood that a registered public accounting firm will catch any significant deficiencies before it issues its audit report. As a result, more work may be necessary under this standard than performed under the existing requirements for concurring partners. However, Auditing Standard No. 7 explains that the procedures required by the engagement quality reviewer are different in nature than those required to be performed by the engagement team. Further, if the engagement quality reviewer deems more work is required before giving approval of issuance, the engagement team is responsible for completing that work.

.74 This standard applies to all audit engagements, and engagements to review interim financial information, conducted pursuant to the standards of the PCAOB, and it supersedes the PCAOB's interim concurring partner review requirement. Auditing Standard No. 7 is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009. For a public, calendar-year company, this standard is applicable for the quarter ended March 31, 2010. For the full text of the standard, readers are encouraged to visit the PCAOB's website at www.pcaob.org.

Question and Answer on Auditing Standard No. 7

.75 Subsequent to the issuance of Auditing Standard No. 7, the PCAOB issued Staff Question and Answer, *Auditing Standard No. 7*, Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10), to provide further implementation guidance on the documentation requirements of the standard. This guidance focuses on the required documentation of the interactions between the engagement quality reviewer and the engagement team, specifically as it relates to a specific example in Auditing Standard No. 7. The question and answer clarifies that the standard does not require documentation of all of the interactions between the engagement quality reviewer and the engagement team. Further, it explains that the example is intended to illustrate how the documentation requirements of the standard should be applied once a reviewer concludes that a significant engagement deficiency exists. This question and answer can be located at http://pcaobus.org/Standards/QandA/2010-02-19_EQR_QA%20_2.pdf.

PCAOB Practice Alert on Using the Work of Others

.76 In July 2010, the PCAOB issued Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06), because it observed that a number of registered public accounting firms located in the United States have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the United States. This practice alert contains reminders for registered firms of their obligations when using the work of other firms or using assistants engaged from outside the firm, such as in the aforementioned situation. It also describes the circumstances under which the firm issuing the audit report may use the work and reports of another auditor.

.77 Auditors who engage assistants from outside their firm are governed by the same standards regarding planning the audit and supervising assistants when audit work is performed by assistants employed by the auditor's firm. Observations from the PCAOB's inspection process suggest that some firms may be issuing

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audit reports based on the work of another firm, or using the work of assistants engaged from outside the firm, without complying with the relevant PCAOB standards. The practice alert is broken down into two sections:

- Using the work of other auditors. This discussion is based upon AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1).
- Engaging assistants from outside the firm. This discussion is based upon numerous sections of auditing guidance.

.78 The full text of this practice alert can be found at http://pcaobus.org/Standards/QandA/2010-07-12_APA_6.pdf.

PCAOB Practice Alert on Significant Unusual Transactions

.79 In April 2010, the PCAOB issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05), which is intended to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions. Practice Alert No. 5 compiles existing requirements from PCAOB standards and groups them into the following categories: identifying and assessing risks of material misstatement, responding to risks of material misstatement, consulting others, evaluating financial statement presentation and disclosure, communicating with audit committees, and reviewing interim financial information. Practice Alert No. 5 can be accessed at http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf.

Supplementary and Other Information Related to Financial Statements

.80 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.81 Statement on Auditing Standards (SAS) No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information. *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

Supplementary Information in Relation to the Financial Statements as a Whole

.82 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of generally accepted auditing standards (GAAS), *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

.83 The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This SAS also may be applied, with the report wording adapted as necessary, when an auditor has been engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Required Supplementary Information

.84 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558), addresses the auditor's responsibility with respect to *required supplementary information*. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. SAS No. 120 explains that the objectives of the auditor, when a designated accounting standard setter requires information to accompany an entity's basic financial statements, are to perform specified procedures in order to

- describe, in the auditor's report, whether required supplementary information is presented and
- communicate therein when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter.

Auditing Fair Value Measurements

.85 In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with U.S. GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

.86 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding

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of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB ASC 820, *Fair Value Measurements and Disclosures*, under U.S. GAAP this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.
- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)
- The reasonableness of the determination within the fair value hierarchy of inputs.

Fair Values of Securities

.87 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB ASC 820, quoted prices in active markets are considered level 1 inputs.

.88 When an entity performs its own valuation, value testing procedures include the following:

- Assessing the reasonableness
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

.89 Whether the inputs to the entity's valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB ASC 820. When extensive judgment is needed, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.90 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles. The auditor also should evaluate management's conclusions regarding other-than-temporary impairment on its securities. Examples of factors that could cause an other-than-temporary impairment, per paragraph .47 of AU section 332, include the following:

- Fair value is significantly below cost and
  - — the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - — the decline has existed for an extended period of time.
  - — management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

.91 Auditors should consider all facts and circumstances when determining if an other-than-temporary impairment has occurred. Additionally, the classification of an entity's securities is based on management's intent and ability. The auditor should obtain an understanding of management's classification process among trading, available-for-sale, and held-to maturity, as well as consider the classifications in light of the entity's current financial position.

Auditing Accounting Estimates

.92 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, impairment analysis and estimated useful lives of long lived assets, valuation allowance for deferred tax assets, and actuarial assumptions in pension and other postretirement benefit costs.

.93 Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

.94 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet earnings, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management's accounting estimates with an extra degree of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA,

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Professional Standards, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.95 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342. The AICPA has released a proposed redrafted SAS, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* (Redrafted), on auditing accounting estimates, including fair value. Readers are encouraged to remain alert for developments on this topic.

Auditor Responsibilities for Subsequent Events

.96 To provide guidance related to the effect of Accounting Standard Update (ASU) No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, on the auditor's responsibilities for subsequent events relative to a conduit debt obligor and the date of the auditor's report, the AICPA issued Technical Questions and Answers (TIS) section 8700.03, "Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor" (AICPA, *Technical Practice Aids*), in June 2010. TIS section 8700.03, through an example, explains that management of a conduit debt obligor with conduit debt securities that trade in a public market must evaluate subsequent events through the date the financial statements are first widely distributed (that is, issued). Further, the auditor, using professional judgment, needs to evaluate management's assertion about the financial statement issuance date and decide whether the manner in which the entity has made its financial statements available does or does not constitute issuance for purposes of complying with GAAP and completing the auditor's subsequent event procedures. In accordance with AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1), the auditor has no obligation to make any further or continuing inquiry or perform any other auditing procedures, with respect to the audited financial statements, after the date of the auditor's report, unless new information that may affect the report comes to his or her attention.

.97 In September 2009, the AICPA issued TIS section 8700.02, "Auditor Responsibilities for Subsequent Events" (AICPA, *Technical Practice Aids*), which discusses the effects of the entity's responsibility to disclose the date through which the subsequent events have been evaluated on the auditor's responsibilities for subsequent events. This question and answer was issued in response to FASB's issuance of FASB Statement No. 165, *Subsequent Events* (codified in FASB ASC 855, *Subsequent Events*). Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the auditor's report. This typically will result in the same date being used for both the auditor's report and the date disclosed by management through which they have evaluated subsequent events. The auditor may consider discussing these dating requirements with management in advance of beginning the audit and including any agreed upon understanding in the engagement letter. Recently issued technical questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Communicating Internal Control Related Matters Identified in an Audit

.98 SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), supersedes SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, and further clarifies standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted.

.99 SAS No. 115 is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion), except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1). In general, SAS No. 115 retains many of the provisions of SAS No. 112. The key differences between the two standards lie in the definitions of *material weaknesses* and *significant deficiencies*.

Definitions of Significant Deficiency *and* Material Weakness

.100 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable*, as those terms are defined in the FASB ASC glossary. The FASB ASC glossary defines *reasonably possible* as when the chance of the future event or events occurring is more than remote but less than likely; *probable* is defined as when the future event or events are likely to occur. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

The Evaluation Process

.101 Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. Further, the severity of a deficiency does not depend on whether a misstatement actually occurred.

.102 The AICPA published the Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Consideration of an Entity's Ability to Continue as a Going Concern

.103 The consideration of an entity's ability to continue as a going concern is required in every audit performed under GAAS and continues to be an especially important consideration in the current state of the economy, as discussed in the "Reporting Trends" section of this alert. An entity's ability to continue as a going concern is affected by many factors, such as the industry and geographic area in which it operates, the financial health of its customers and suppliers, and its accessibility to financing.

.104 As explained by paragraph .02 of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), the auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at, or have occurred prior to, the date of the auditor's report. Therefore, this is an ongoing evaluation that extends through the date of the auditor's report.

.105 The auditor has a responsibility to evaluate whether there is a substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. AU section 341 notes that is a period not to exceed one year beyond the date of the financial statements being audited. Audit teams may find it useful to have preliminary discussions about going concern considerations during engagement planning meetings; however, as noted in AU section 341, it is not necessary to design audit procedures around specifically identifying the possibility of a going concern issue because results of typical audit procedures

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should illuminate any indicators. These procedures may consist of analytical procedures, review of subsequent events, review of compliance with financing agreements, review of board minutes, inquiry of legal counsel, and confirmation with related third parties of the details of arrangements to provide or maintain financial support.

.106 If the auditor believes that a substantial doubt about the entity's ability to continue as a going concern exists, the next steps are to obtain management's plans to mitigate the effect of such conditions and then assess the likelihood that these plans can be implemented effectively. If, after considering management's plan, an auditor determines that a substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should communicate with those charged with governance of the entity, in accordance with AU section 341. In that instance, the auditor also should consider the effects on the entity's financial statements and the adequacy of the related disclosure, and an explanatory paragraph should be added to the audit report following the opinion paragraph. Alternatively, if management's plan mitigates the risk of the entity's inability to continue as a going concern, the auditor should consider disclosing the primary conditions that gave rise to the initial doubt and management's plans. These disclosures are especially important for financial statement users to fully comprehend the entity's financial strength and ability to continue as a going concern.

.107 The auditor's assessment of whether an entity's ability to continue as a going concern may have a significant impact on an entity's business, either if it is a going concern or if it is not. Because the auditor's professional judgment is frequently the basis for whether a going concern issue exists, it is important that the auditor carefully consider the impact of his or her judgment on the users of the client's financial statements and to what extent management's plans may have alleviated the substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Further, a premature going concern paragraph may have detrimental effects on an entity and become a self-fulfilling prophecy.

.108 FASB has undertaken a project that will incorporate going concern guidance into accounting literature. One of the expected major changes is regarding the going concern time frame. FASB decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. The time frame beyond 12 months is limited to a practical amount of time thereafter in which significant events or conditions that may affect the evaluation can be identified. An exposure draft is expected in the fourth quarter of 2010; readers should be alert for its issuance.

Service Organizations

.109 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801), contains the requirements for reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU sec. 324. Once the new SAS becomes effective, it will replace the guidance for user auditors currently in AU sec. 324. SSAE No. 16 is based on the International Auditing and Assurance Standards Board's (IAASB's) International Standard on Assurance Engagements No. 3402, *Assurance Reports on Controls at a Service Organization*, and the new SAS is based on the IAASB's International Standard on Auditing (ISA) 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

.110 SSAE No. 16 is applicable when an entity outsources a business task or function to another entity (usually one that specializes in that task or function) and the data resulting from that task or function is incorporated in the outsourcer's financial statements. The SSAE defines a *service organization* as an organization or segment of an organization that provides services to user entities, which are likely to be relevant to those user entities' internal control over financial reporting; a *user entity* is defined as an entity that uses a service organization; and a *service auditor* is defined as a practitioner who reports on controls at a service organization. Some examples of service organizations are an entity that processes medical claims for health insurance companies, an investment adviser that maintains accountability for those assets and provides statements to user entities, and a data center that provides applications and technology that enable user entities to process financial transactions.

.111 SSAE No. 16 discusses the requirements and guidance for a service auditor reporting on a service organization's controls. Among the changes made to the guidance, two major changes would affect a service auditor's engagement: (*a*) management of the service organization will now be required to provide the service auditor with a written assertion about the fairness of the presentation of the description of the system and about the suitability of the design and, in a type 2 engagement, the operating effectiveness of controls, and (*b*) in a type 2 engagement, the description of the service organization's system and the service auditor's opinion on the description will cover a period (the same period as the period covered by the service auditor's tests of the operating effectiveness of controls). SSAE No. 16 enables a service auditor to perform two types of engagements:

- A *type 1 engagement* is when the service auditor reports on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date.
- A *type 2 engagement* is when the service auditor reports on the fairness of the presentation of management's description of the service organization's system and the suitability of the design and operating effectiveness of the controls to achieve the related control objectives included in the description throughout a specified period.

.112 A service auditor's report provides useful information only to a user organization that actually uses those services and needs that information to make decisions about its own internal control over financial reporting. Therefore, use of an SSAE No. 16 report is restricted to user entities that are customers of the service organization and user auditors (this restriction was also present for a SAS No. 70 report). An SSAE No. 16 report is not intended to be used as a marketing or sales tool by the client. As with SAS No. 70 reports, there is no such thing as being "SSAE No. 16 certified." It is a popular misconception that a service organization can become "certified" as compliant after undergoing a service auditor's engagement. An SSAE No. 16 report is primarily an auditor-to-auditor communication. Further, SSAE No. 16 (as well as SAS No. 70), does not apply to examinations of controls over subject matter other than financial reporting. These engagements would be performed under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1).

.113 The AICPA is in the process of overhauling and rewriting the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (commonly known as the SAS 70 guide). Also, to address reporting on a service provider's controls over subject matter other than financial reporting, the AICPA is developing a new Audit Guide, *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*. Both guides are expected to be available for sale in early 2011. The AICPA is also in the process of drafting communication materials that will help auditors, clients, and users understand the three types of service organization control (SOC) reports (formerly SAS No. 70 reports) to be used for reporting on these engagements.

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	Title	*Description*
SOC 1	*Report on Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting*	To be used only in circumstances when the service organization's services and controls affect the internal control over financial reporting for the entities that use the service.
SOC 2	*Report on Controls at a Service Organization relevant to Security, Availability, Processing Integrity, Confidentiality, and Privacy*	The purpose is to convey trust and assurance to users of the system that the service organization has deployed an effective control system to effectively mitigate operational and compliance risks that the system may represent to its users.
SOC 3	*Trust Services Report*	These reports are designed to meet the needs of users who want assurance on the controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy of a system but do not have the need for the level of detail provided in an SOC 2 report. These reports are general use reports and can be freely distributed or posted on a website as a seal.

Compilation and Review Engagements

.114 The AICPA developed a brand new guide, *Compilation and Review Engagements*, which provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

Accounting Issues and Developments

Accounting for Certain Distributions to Shareholders

.115 In January 2010, FASB issued ASU No. 2010-01, *Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*. This ASU affects entities that declare dividends to shareholders that may be paid in cash or shares at the election of the shareholders, with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate. The amendments in this ASU clarify that the stock portion of the distribution that allows the shareholders to elect or receive cash or shares, with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate, is considered a share issuance. The intent is to eliminate the current diversity in practice. These amendments are effective for interim and annual periods ending on or after December 15, 2009, and should be applied on a retrospective basis.

Accounting for Uncertainty in Income Taxes

.116 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities, and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for

as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.

- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FASB ASC 740-10-50-15[a]–[b]).

.117 For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009.

.118 In June 2010, to clarify some practice issues related to FASB ASC 740-10, the AICPA issued TIS section 5250.14, "Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes," and TIS section 5250.15 "Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions" (AICPA, *Technical Practice Aids*). TIS section 5250.14 explains that the scope of FASB ASC 740-10 applies to income taxes only (not sales, payroll, and other taxes). Entities should follow the guidance contained in FASB ASC 450, *Contingencies*, to account for uncertainties in taxes other than income taxes. TIS section 5250.15 clarifies that the disclosure requirements in paragraph 15(c)–(e) of FASB ASC 740-10-50 remain in effect (if applicable), regardless of whether an entity has any uncertain tax positions. Those disclosure requirements include the following:

- The total amounts of interest and penalties recognized in both the statement of operations and the statement of financial position
- For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date, the nature of the uncertainty, the nature of the event that could occur in the next 12 months that would cause the change, and an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made
- A description of tax years that remain subject to examination by major tax jurisdictions

.119 Recently issued technical questions and answers of the AICPA can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Decreases in Ownership of a Subsidiary

.120 In January 2010, FASB issued ASU No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*. This ASU addresses implementation issues related to the changes in ownership provisions in FASB ASC 810-10 (issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*). FASB ASC 810-10 requires an entity to deconsolidate a subsidiary when the entity ceases to have a controlling financial interest in the subsidiary. Upon deconsolidation, an entity recognizes a gain or loss on the transaction and measures any retained investment in the subsidiary at fair value. That gain or loss includes any gain or loss associated with the difference between the fair value of the retained investment in the subsidiary and its carrying amount at the date the subsidiary is deconsolidated. This guidance aligns the accounting for both business combinations and dispositions by recognizing any preexisting interest or retained investment in a subsidiary at its fair value. In contrast, an entity is required to account for a decrease in its ownership interest of a subsidiary that does not result in a change of control as an equity transaction.

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.121 These amendments affect any entity that experiences a decrease in ownership in a subsidiary that is a business or nonprofit activity, plus any entity that exchanges a group of assets that constitutes a business or nonprofit activity for an equity interest in another entity. These amendments clarify that the scope of the decrease in ownership provisions of FASB ASC 810-10 and related guidance apply to the following:

- A subsidiary or group of assets that is a business or nonprofit activity
- A subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture
- An exchange of a group of assets that constitutes a business or nonprofit activity for a noncontrolling interest in an entity (including an equity method investee or joint venture)

.122 Further, the amendments clarify that the decrease in ownership guidance in FASB ASC 810-10 does not apply to the following transactions, even if they involve businesses:

- Sales of in-substance real estate
- Conveyances of oil and gas mineral rights

.123 The amendment also expands the required disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of FASB ASC 810-10. This ASU is effective beginning in the period that an entity adopts FASB Statement No. 160. If an entity has already adopted this guidance, then the amendments in this ASU are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this ASU should be applied retrospectively to the first period that an entity adopted FASB Statement No. 160.

Consolidation of Variable Interest Entities

.124 For calendar year entities, 2010 is the first year of application of FASB Statement No. 167, which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB Statement No. 167 was incorporated into FASB ASC through FASB ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. As explained by FASB ASC 810-10-65-2(i), this guidance may be applied retrospectively in previously issued financial statements for one or more years, with a cumulative-effect adjustment to retained earnings as of the beginning of the first year restated. FASB Statement No. 167 retains the scope of previous variable interest entities (VIE) consolidation accounting guidance, with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, which was incorporated into FASB ASC by ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*. As a result of including qualifying special purpose entities, transferors, sponsors, and investors in those entities must now consider the consolidation and disclosure provisions in FASB Statement No. 167.

.125 FASB Statement No. 167 states that the determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This statement also amends consolidation of VIE guidance to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE, which was based on determining which company absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both. In the new guidance, kickout rights and participating rights are ignored both in the determination of whether an entity is a VIE and in the identification of the VIE's primary beneficiary, unless the rights are held by a single reporting entity.

.126 Under the new guidance, a reporting entity must now continually reconsider which variable interest holder is the VIE's primary beneficiary. Additionally, if equity interest holders lose the power from the voting

rights of those investments to direct the entity's most significant activities, the reporting entity must reconsider an entity's VIE status. Also, a reporting entity must meet six conditions to make the determination that fees paid to a decision maker or service provider do not represent a variable interest. Fees paid to an enterprise that acts solely as a fiduciary or agent should typically not represent a variable interest in a VIE because those fees would meet all of the conditions. A primary beneficiary must present separately, on the face of the balance sheet, assets of consolidated VIEs that can only be used to settle obligations of those VIEs and liabilities of consolidated VIEs for which creditors do not have recourse to the general credit of the primary beneficiary. Power is only considered shared (and no party consolidates) if two or more unrelated parties together have the power to direct the VIE's most significant activities and decisions about those activities require the consent of each of the parties sharing power.

.127 Only substantive terms, transactions, and arrangements, whether contractual or noncontractual, should be considered when applying this guidance. Any term, transaction, or arrangement that does not have a substantive effect on an entity's status as a VIE, an enterprise's power over a VIE, or an enterprise's obligation to absorb losses or its right to receive benefits of the entity should be disregarded when applying the provisions of this guidance. Judgment, based on all facts and circumstances, is needed to make this determination.

.128 This statement also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a VIE or disclose information about its involvement in a variable interest entity, or both
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks associated with an enterprise's involvement with the VIE
- How an enterprise's involvement with the VIE affects the enterprise's financial position, financial performance, and cash flows

SEC Considerations on FASB Statement No. 167

.129 The SEC staff shared with the Center for Audit Quality (CAQ) SEC Regulations Committee its FASB Statement No. 167 views regarding transition questions for SEC registrants and the internal control over financial reporting requirements for an entity newly consolidated pursuant to this guidance.

.130 The SEC staff indicated that if an entity has elected to adopt FASB Statement No. 167 retrospectively and has filed interim financial statements for a period that includes the date of adoption, that registrant must recast its prior period annual financial statements that are incorporated by reference to reflect a material retrospective application of FASB Statement No. 167. Conversely, if a registrant elects to adopt FASB Statement No. 167 only on a prospective basis, or if the retrospective application of the guidance is not material, its registration statement may incorporate by reference its most recent Form 10-K, which would include its historical annual financial statements of periods prior to the adoption of FASB Statement No. 167 (assuming that the prior financial statements do not require revision for other purposes).

.131 An SEC registrant must present in its Form 10-K three years of comparative income statements and two years of comparative balance sheets (two years of comparative income statements and balance sheets for a smaller reporting company). The Form 10-K of an SEC registrant that is not a smaller reporting company also must include a table of selected financial data for the past five years (or a longer period at the registrant's option). This creates another issue addressed by the SEC staff, which is whether an SEC registrant that retrospectively applies FASB Statement No. 167 to all periods presented in its financial statements would be permitted to retrospectively apply the effects of the guidance to any additional periods presented in the table of selected financial data. The SEC staff indicated that it expects there to be consistency between the

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application of FASB Statement No. 167 in the financial statements and in the table of selected financial data. In all cases, the SEC staff expects a registrant to disclose to which periods it has retrospectively applied FASB Statement No. 167 and, if necessary, the fact that certain periods are not comparable to the periods for which the audited financial statements are provided. For example, if a calendar year-end entity adopts FASB Statement No. 167 on January 1, 2010, and elects to retrospectively apply it to fiscal years 2009 and 2008, the entity will record a cumulative effect adjustment to retained earnings as of January 1, 2008. The registrant may decide whether it will also apply FASB Statement No. 167 to fiscal years 2006 and 2007 within the selected financial data table.

.132 The SEC staff also commented on the internal control over financial reporting considerations related to FASB Statement No. 167. The SEC staff stated that VIEs consolidated upon adoption of the guidance should be included in management's reports on internal control over financial reporting. Because the criteria for consolidation of a VIE are now based upon control, a registrant will no longer be able to justify excluding consolidated VIEs from the scope of its internal controls assessment because it will likely have the right or authority to assess the internal controls of those VIEs. Further, because the consolidation of VIEs will occur as of the first day of the registrant's fiscal year, the registrant will have sufficient time to perform that assessment and would be unable to rely on the temporary relief provided under the SEC staff's third question in *Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions* (Section 4310.11 of the Division of Corporation Finance *Financial Reporting Manual*). However, the SEC staff did explain that after adoption of FASB Statement No. 167, an SEC registrant may apply the guidance in the third question when considering whether it would be appropriate to exclude a VIE that is newly consolidated due to events or changes in circumstances from the scope of its internal control assessment in the fiscal year consolidation first occurs, if an internal control assessment is not possible.

.133 Additionally, the guidance contained in the first question continues to apply only in the rare circumstance in which the VIE was in existence prior to December 15, 2003, and the registrant, despite having control, does not possess the right or authority to assess the VIE's internal controls and lacks the ability, in practice, to make that assessment. Registrants may continue to follow the guidance in the first question in this rare circumstance.

.134 In early June 2010, a speech given by a member of the Office of the Chief Accountant at the SEC discussed the issue of structuring transactions to achieve an accounting result, specifically in regard to FASB Statement No. 167. The speech reinforces the guidance in the new standard, specifically that the substance of an arrangement should be considered, not just the form; further, nonsubstantive terms should be disregarded when determining who makes the key decisions that most significantly impact an entity's economic performance. The speech also discusses the SEC's thoughts with regard to certain strategies that entities may use to avoid consolidation. The overarching themes were that significant judgment is required in determining whether a controlling financial interest exists in complex fact patterns and that the Office of the Chief Accountant is available if a registrant would like to consult regarding its accounting for unusual transactions when it believes the application of GAAP is unclear. The full text of the speech can be accessed at www.sec.gov/news/speech/2010/spch060310pab.htm.

Application of Consolidation Requirements for Certain Investment Funds

.135 In February 2010, FASB issued ASU No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*. This ASU defers the amendments to consolidation guidance from FASB Statement No. 167 for a reporting entity's interest in an entity that has all the attributes of an investment company, as specified in FASB ASC 946, *Financial Services—Investment Companies*, or for which it is industry practice to apply measurement principles for financial reporting that are consistent with those in FASB ASC 946. The deferral also applies to a reporting entity's interest in an entity that is required to comply with or operate in accordance with requirements that are similar to those included in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. ASU No. 2010-10 does not defer the disclosure requirements in FASB Statement No. 167. For further details, including to whom the deferral does not apply, readers are encouraged to review the full text of ASU No. 2010-10, which can be found on FASB's website.

Accounting for Transfers of Financial Assets

.136 Calendar year entities must also start applying the provisions of FASB Statement No. 166 in 2010. FASB Statement No. 166, which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, requires more information about transfers of financial assets, including securitization transactions, and those circumstances in which entities have continuing exposure to the risks related to transferred financial assets. FASB Statement No. 166 was incorporated into FASB ASC by FASB ASU No. 2009-16 and is discussed in FASB ASC 860, *Transfers and Servicing*. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets.

.137 Historically, accounting for transfers in which the transferor has no continuing involvement with the transferred financial assets or transferee has not been controversial. However, transfers of financial assets with continuing involvement raise questions about the circumstances under which the transfers should be accounted for as sales or secured borrowings and about how transferors and transferees should account for sales and secured borrowings. This guidance is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

.138 Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. All transferees, including VIEs, must now be evaluated for consolidation, unless another exception is available. This aspect of the new guidance is considered by many to have the most profound effect. Additionally, the special provisions for guaranteed mortgage securitizations have been removed, and those securitizations will be treated the same as any other transfer of financial assets within FASB ASC 860. If such securitizations do not meet the requirements for sale treatment accounting, the securitized mortgage loans will continue to be classified as loans in the transferor's statement of financial position. The transferor also would not separately recognize a servicing asset or servicing liability.

.139 The amendments also modify the financial components approach and limit the circumstances in which a transferor derecognizes a portion or component of a financial asset when the transferor has not transferred the original financial asset or when the transferor has continuing involvement with the financial asset. The unit of account eligible for sale accounting is limited to an entire financial asset, a group of entire financial assets, or a participating interest in an entire financial asset (as defined in "Pending Content" of FASB ASC 860-10-40-6A). Inherent in this requirement is that an entire financial asset cannot be divided into components prior to a transfer, with those components being eligible for derecognition upon transfer, unless all of the components meet the definition of a participating interest. The legal isolation analysis is clarified in the new guidance to ensure that the financial asset has been put beyond the reach of the transferor, its consolidated affiliates (affiliates that are not entities designed to make remote the possibility that they would enter bankruptcy or other receivership) included in the financial statements being presented, and its creditors.

.140 The principle of effective control is also clarified so that the transferor must evaluate whether it, its consolidated affiliates included in the financial statements being presented, or its agents effectively control the transferred financial asset(s) directly or indirectly. Further, when evaluating transfers of financial assets for derecognition, an entity must consider all arrangements or agreements made contemporaneously with, or in contemplation of, a transfer, even if not entered into at the time of the transfer. Also, the practicability

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exception from measuring the proceeds received by a transferor in a transfer that qualifies for sale accounting at fair value has been removed.

.141 The primary objectives of the disclosure requirements of this guidance are to provide the financial statement users with a clear understanding of the following:

- A transferor's continuing involvement (as defined by the FASB ASC glossary), if any, with transferred financial assets
- The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- How servicing assets and servicing liabilities are reported under this pronouncement
- For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows

.142 These objectives must be met by the disclosures, regardless of the specific requirements of the pronouncement. It may be the case that an entity provides greater detail than what is a required disclosure to meet these objectives, depending on the facts and circumstances.

Subsequent Events

.143 FASB Statement No. 165, which has been codified in FASB ASC 855, became effective for interim and annual periods ending after June 15, 2009, and establishes general standards of accounting for, and disclosure of, events that occur after the balance sheet date but before financial statements are issued or are available to be issued. In September 2009, the AICPA issued TIS section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), which notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. This question and answer can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

.144 In February 2010, FASB issued ASU No. 2010-09 to address questions that arose in practice about potential conflicts between FASB ASC 855 and SEC guidance—specifically, the requirements to disclose the date that the financial statements are issued. This ASU also addresses the intended breadth of the reissuance disclosure provision related to subsequent events.

.145 ASU No. 2010-09 requires an entity that is an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market to evaluate subsequent events through the date the financial statements are issued. As stated in the definition of *financial statements are issued* in the FASB ASC glossary, financial statements are considered issued when they are widely distributed to shareholders and other financial statement users for general use and reliance in a form and format that complies with GAAP. All other entities must evaluate subsequent events through the date the *financial statements are available to be issued*; as defined by the FASB ASC glossary, this is when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained (for example from management, the board of directors, or significant shareholders). Further, an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. Lastly, only non-SEC filers should disclose in the revised financial statements the dates through which subsequent events have been evaluated in both the issued or available-to-be-issued financial statements and the revised financial statements. Revised financial statements are considered reissued financial statements. The amendments in ASU No. 2010-09 are effective upon issuance, except for the use of the issued date for conduit bond obligors. That amendment is effective for interim or annual periods ending after June 15, 2010. TIS section 8700.03 was issued by the AICPA in June 2010 to provide guidance on the application of ASU No. 2010-09, relative to a conduit debt obligor, and is discussed in the "Auditor Responsibilities for Subsequent Events" section of this alert.

Fair Value

.146 FASB ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity. *Fair value* is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

.147 FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both

- does not have a readily determinable fair value. The FASB ASC glossary states that an equity security has a readily determinable fair value if it meets any of the following conditions:
  - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year.
  - The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.
  - The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.
- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes are not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946.

.148 As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the net asset value (NAV) per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

.149 This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

.150 These amendments are effective for interim and annual periods ending after December 15, 2009, and are included in FASB ASC 820-10. An AICPA practice aid, *Alternative Investments—Audit Considerations*, also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments.

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.151 In December 2009, the AICPA issued sections .18–.27 of TIS section 2220, *Long-Term Investments* (AICPA, *Technical Practice Aids*), to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers compliment the guidance provided in ASU No. 2009-12.

.152 Topics covered in these questions and answers include the following:

- The circumstances when NAV may be used to estimate the fair value of investments as a practical expedient
- How to identify the unit of account for interests in alternative investments
- Considerations for determining whether the reported NAV has been calculated in a manner consistent with FASB ASC 946
- Examples of circumstances when an adjustment to the reported NAV may be necessary
- How to adjust the reported NAV when it is not as of the reporting entity's measurement date
- How to adjust the reported NAV when it has not been calculated in accordance with FASB ASC 946
- The determination of the appropriate level within the fair value hierarchy for NAV of alternative investments in relation to the ability to redeem the investment versus the actual redemption request for the investment
- The definition of *near term* for the purposes of determining the appropriate level within the fair value hierarchy
- The tailoring of disclosures categories to address the nature and risks of investments
- Some considerations for determining the fair value of alternative investments when not utilizing NAV as a practical expedient

.153 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurements Disclosures

.154 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers between the three levels and the underlying reasons for such transfers would be useful to financial statements users.

.155 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.156 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the

statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.

- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.157 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

.158 In June 2010, the AICPA issued TIS section 1800.05, "Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments" (AICPA, *Technical Practice Aids*). TIS section 1800.05 explains that the measurement principles of FASB ASC 820 do apply to financial instruments that are not recognized at fair value in the statement of financial position but for which fair value is required to be disclosed in the financial statement notes in accordance with paragraphs 10–19 of FASB ASC 825-10-50. On the other hand, the fair value disclosure requirements of FASB ASC 820-10-50 do not apply to financial instruments that are not recognized at fair value in the statement of financial position. For the complete discussion of these conclusions, readers are encouraged to refer to the full text of the question and answer. Recently issued technical questions and answers can be located on the AICPA's website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Subsequent Declines in Market Value

.159 The AICPA issued TIS section 9070.06, "Decline in Market Value of Assets Subsequent to the Balance Sheet Date" (AICPA, *Technical Practice Aids*), in June 2010 to provide guidance to accountants on the appropriate treatment of declines in the market value of an asset subsequent to the balance sheet date. Through references to FASB ASC 855-10, TIS section 9070.06 clarifies that an entity should only recognize the effects of conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date, but before financial statements are issued or are available to be issued, are specifically identified as an example of a nonrecognized subsequent event.

Disclosures About Credit Quality and Allowance for Credit Losses

.160 In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. The ASU amends the existing disclosures to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis:

- A rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method. For each disaggregated ending balance, the related recorded investment in financing receivables should also be disclosed.
- The nonaccrual status of financing receivables by class of financing receivables.
- Impaired financing receivables by class of financing receivables.

.161 The amendments in this ASU require an entity to provide the following additional disclosures about its financing receivables:

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- Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables (see FASB ASC 310-10-55-19 for examples of credit quality indicators)
- The aging of past due financing receivables at the end of the reporting period by class of financing receivables
- The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment

.162 An entity must also describe, by portfolio segment, its accounting policies and methodology used to estimate its allowance for credit losses, including the identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

.163 The amendments in this ASU apply to all entities with financing receivables. Examples of financing receivables include loans; trade receivables; notes receivable; and receivables relating to a lessor's leveraged, direct financing, and sales-type leases. See the "Pending Content" in paragraphs 13–15 of FASB ASC 310-10-55 for more information on the definition of *financing receivable*, including a list of items that are excluded from the definition (for example, debt securities). In addition, the "Pending Content" in paragraphs 7–12 of FASB ASC 310-10-55 illustrates certain disclosures required by this ASU.

.164 For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

Embedded Credit Derivatives

.165 FASB issued ASU No. 2010-11, *Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*, in March 2010 to address questions that have arisen in practice about the intended breadth of the embedded credit scope exception discussed in paragraphs 8–9 of FASB ASC 815-15-15. ASU No. 2010-11 clarifies the aforementioned scope exception for embedded credit derivative features related to the transfer of credit risk in the form of subordination of one financial instrument to another. This ASU addresses how to determine which credit derivative features, including those in collateralized debt obligations and synthetic collateralized debt obligations, are considered to be embedded derivatives that should not be analyzed under FASB ASC 815-15-25 for potential bifurcation and separate accounting. Further, the ASU explains that upon initial adoption of its amendments, an entity may elect the fair value option for any investment in a beneficial interest in a securitized financial asset. The amendments in this ASU are effective for each reporting entity at the beginning of its first fiscal quarter beginning after June 15, 2010. Early adoption is permitted at the beginning of each entity's first fiscal quarter beginning after the issuance of this ASU.

Share-Based Payment Awards Denominated in a Different Currency

.166 In April 2010, FASB issued ASU No. 2010-13, *Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*. This ASU clarifies that an employee share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should not be considered to contain a condition that is not a market, performance, or service condition. Therefore, such an award should not be classified as a liability if it otherwise qualifies as equity. A share-based payment award that contains a condition that is not a market, performance, or service condition is required to be classified as a liability.

.167 This ASU affects entities that issue employee share-based payment awards with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades that differs from the functional currency of the employer entity or payroll currency of the employee. This will also affect any entities that have previously considered such awards to be liabilities because of their exercise price. For example, a parent entity whose functional currency is the Canadian dollar grants equity share options with an exercise price denominated in U.S. dollars to employees of a Canadian entity with the functional and payroll currency of the Canadian dollar. If a substantial portion of the parent entity's equity securities trades on a U.S. dollar denominated exchange, the options are not precluded from equity classification.

.168 The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2010; early adoption is permitted. These amendments should be applied by recording a cumulative-effect adjustment to the opening balance of retained earnings. The cumulative-effect adjustment should be calculated for all awards outstanding as of the beginning of the fiscal year in which the amendments are initially applied as if the amendments had been applied consistently since the inception of the awards; the adjustment should also be presented separately.

Certificates of Deposit

.169 To provide additional guidance to constituents on the accounting and reporting on certificates of deposit, the AICPA staff issued three technical questions and answers in June 2010. TIS section 2130.40, "Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*" (AICPA, *Technical Practice Aids*), explains that, in accordance with the definition of *security* as stated by FASB ASC 320-10-20, certificates of deposit are typically not within the scope of FASB ASC 320, *Investments—Debt and Equity Securities*. That definition states that a *security* is a share, participation, or other interest in property or an entity of the issuer or an obligation of the issuer that has all of the following characteristics: (*a*) it is either represented by an instrument issued in bearer or registered form or, if not represented by an instrument, is registered in books maintained to record transfers by or on behalf of the issuer; (*b*) it is of a type commonly dealt in on securities exchanges or markets or, when represented by an instrument, is commonly recognized in any area in which it is issued or dealt in as a medium for investment; and (*c*) it either is one of a class or series or by its terms is divisible into a class or series of shares, participations, interests, or obligations. However, certain negotiable certificates of deposit may meet that definition and, therefore, may be subject to FASB ASC 320.

.170 Further, TIS section 2130.38, "Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*" (AICPA, *Technical Practice Aids*), explains that certificates of deposit that do not meet the aforementioned definition of a security are not subject to the disclosure requirements of FASB ASC 820-10-50. Negotiable certificates of deposit that do meet that definition will be required to make those disclosures if they are not classified as held to maturity.

.171 Regarding classification on the balance sheet, TIS section 2130.39, "Balance Sheet Classification of Certificates of Deposit" (AICPA, *Technical Practice Aids*), states that certificates of deposit with original maturities of 90 days or less are commonly considered cash and cash equivalents under FASB ASC 305, *Cash and Cash Equivalents*. Those with greater original maturities and not defined as a security (in accordance with FASB ASC 320-10-20) could be included in the line item "investments—other." An example policy and procedures note disclosure is included in TIS section 2130.39.

FASB Statement No. 168

.172 FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, as codified in FASB ASC 105, *Generally Accepted Accounting Principles*, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include

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all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in their financial statements.

Referencing FASB ASC in Your Documentation

.173 You should consider how your entity will reference FASB ASC in your documentation (policy and procedures, technical memorandums, financial statements and filings, engagement working papers, and so on). It is only prudent to reflect current U.S. GAAP in your documentation. The FASB Notice to Constituents (NTC) includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*." Conversely, FASB suggests using the detailed numerical referencing system in working papers, articles, textbooks, and related items.

.174 Also, because FASB ASC is not intended to change U.S. GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate. It is prudent to expect that audit, attest, or compilation and review working papers associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

.175 However, if your entity will continue to follow grandfathered guidance not included in FASB ASC, it would still be appropriate to reference those standards (and not FASB ASC). A listing of examples of grandfathered guidance can be found in FASB Statement No. 168.

.176 Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/FASBAccountingStandardsCodification.aspx.

Postcodification FASB References

.177 In spring 2010, the AICPA judgmentally selected 50 SEC filers and reviewed their 2009 Form 10-Ks to understand what type of references are actually being used in practice. All financial statements reviewed were for those entities having a fiscal year-end between December 1, 2009, and January 31, 2010, when the FASB codification was fully effective for all of these entities. The entities selected comprised the following:

- Fourteen large accelerated filers (28 percent of the sample)
- Twenty accelerated filers (40 percent of the sample)
- Seven nonaccelerated filers (14 percent of the sample)
- Nine smaller reporting companies (18 percent of the sample)

.178 Of all the entities selected, 50 percent had gone to mostly plain English references in their annual financial statements. However, among these entities, in the "Summary of Significant Accounting Policies" section of the financial statements, many entities did still use specific references to either old FASB standards (pre-FASB Statement No. 168 standards or legacy standards) or specific ASUs, when appropriate. There did not seem to be much of a difference in this percentage among large accelerated filers, accelerated filers, and nonaccelerated filers. However, smaller reporting companies were less likely to use plain English (only 33 percent used plain English references).

.179 As for the remaining 50 percent of filers selected, they chose to use either FASB ASC-specific references (36 percent) or to do some sort of dual references (12 percent) between the precodification standards and new FASB ASC guidance. There was one entity that continued to use the old FASB references and did not mention FASB ASC in its financial statements.

.180 For those entities using FASB ASC references, most only referenced to the topic level and did not go down to the subtopic or section level. For those using dual references, in most cases, the new FASB ASC topic was listed first, with the historical FASB reference noted parenthetically. See the following table for a full breakout of the results:

	Plain English References	*FASB ASC References*	*Dual References*	*Old FASB References*
Large Accelerated Filers	7	4	2	1
Accelerated Filers	12	6	2	0
Nonaccelerated Filers	3	3	1	0
Smaller Reporting Companies	3	5	1	0
Total Sample	25	18	6	1

.181 The sampling results make it clear that although both FASB and the SEC have stated that the use of plain English is most appropriate when dealing with financial statements and notes to financial statements, not everyone is there yet. It will be interesting to see if the plain English references trend continues upward once entities have had another full year to get used to FASB ASC. In addition, all new guidance issued in 2010 was issued through ASUs, and there were no legacy standards issued. Therefore, we would expect that in 2010 filings, even the "Summary of Significant Accounting Policies" section of financial statements would no longer refer to any legacy standards.

.182 We found that with the plain English references, some entities chose instead to say something like, "in accordance with the purchase method of accounting and as updated with FASB's April 2009 additional authoritative guidance for business combinations, we...." Here the entity uses plain English but also makes it clear which new guidance they are following. This would be most important for those FASB changes with early adoption provisions to make it clear which method an entity used.

.183 FASB has stated that ASUs do not carry any authority. It is the updates that are made to the codification once the ASU is effective that are authoritative. Therefore, entities would be wise to ensure that when they are referring to authoritative literature, use of either plain English or the FASB ASC references would be appropriate, rather than just naming the ASU that brought about the change in accounting.

.184 In addition, entities would want to be sure that they do not refer to any legacy standards in their 2010 financial statements. Because all changes made to the codification in 2010 were through ASUs, referring to legacy standards is no longer correct. For example, since the codification became effective, there have been several updates to the *Fair Value Measurements and Disclosures* topic. Therefore, referring to FASB Statement No. 157, *Fair Value Measurements*, is no longer accurate because this standard does not incorporate changes made since the codification became effective in 2009. We would expect that entities that used dual references to both the legacy standards and FASB ASC references would not continue to use those dual references in 2010 financial statements.

.185 Many entities also have a section of their notes to financial statements titled "Effect of Accounting Pronouncements Not Yet Adopted." In 2010, we would expect the title of this section to change to something like "Effect of Authoritative Accounting Guidance Not Yet Adopted."

.186 It will be interesting to see if both public and nonpublic entities make any additional refinements or changes to their 2010 financial statements as we move into our first full year with FASB ASC. It is our understanding that the SEC may be issuing comment letters to those entities that are not properly reflecting the current state of U.S. GAAP in their financial statements, whether that be by using plain English or using the new FASB ASC references.

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Convergence With International Financial Reporting Standards

.187 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and International Financial Reporting Standards (IFRSs) and eliminate the differences between them. In the Norwalk agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

SEC Work Plan for Consideration of IFRSs

.188 In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to the SEC's roadmap on its consideration of global accounting standards, including a confirmation of its continued support for the convergence of U.S. GAAP and IFRSs in order to narrow the differences between the two sets of standards. The SEC believes that a more comprehensive work plan is necessary to transparently lay out the work that must be done to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, time frame, and methodology for any such transition. Therefore, the SEC has indicated that it will carefully consider and deliberate whether these changes are in the best interest of U.S. investors and markets.

.189 The SEC directed its staff to execute a work plan, the results of which will aid the SEC in its evaluation of the impact that the use of IFRSs by U.S. entities would have on the U.S. securities market. The work plan includes consideration of IFRSs, both as they currently exist and after the completion of the various convergence projects underway by FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received on the roadmap, including the following:

- Sufficient development and application of IFRSs for the U.S. reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRSs
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

.190 Beginning no later than October 2010, and frequently thereafter, the SEC staff will provide public progress reports on the work plan, as well as the status of the FASB and IASB convergence projects, until the work is complete. By 2011, assuming completion of these convergence projects and the staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. Commentors provided feedback on the timing discussed in the roadmap, suggesting that a four or five year time frame would be necessary to successfully implement a change in their financial reporting systems to incorporate IFRSs. Under that assumption, if the SEC determines in 2011 to incorporate IFRSs into the U.S. financial reporting system, the first time that U.S. entities would report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of Release No. 33-9109 and also can be found on the SEC's website at www.sec.gov.

.191 In August 2010, the SEC issued two releases (Release Nos. 33-9133 and 33-9134, *Notice of Solicitation of Public Comment on Consideration of Incorporating IFRS Into the Financial Reporting System for U.S. Issuers*) to

solicit public comment on its ongoing consideration of incorporating IFRSs into the financial reporting system for U.S. issuers. The first release contains requests for comment on three topics derived from the work plan that are related to the potential impact on investors. The second release contains requests for comment on three topics, also derived from the work plan, that are related to the potential impact on U.S. issuers. All comments will be available on the SEC's website.

International Financial Reporting Standard for Small and Medium-sized Entities

.192 The IASB issued *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs*) to be a self-contained global accounting and financial reporting standard applicable to the general purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs. *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability.

.193 The AICPA Governing Council recognizes the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01), gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs*, and a private company's expenditure of money, time and effort to convert to *IFRS for SMEs*. Information about IFRSs and *IFRS for SMEs* can be found at www.ifrs.com.

Private Company Financial Reporting

.194 The AICPA and the Financial Accounting Foundation established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel also is sponsored by the National Association of State Boards of Accountancy. The "blue-ribbon panel" will provide recommendations through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies are needed. The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities taking more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries. The panel's issued report will be made available to the public, and the resulting action plan is expected to be exposed for public comment prior to that plan being finalized. Although no deadline has been set for the panel's work, the recommendations are likely to come in 2010.

.195 During the July 2010 meeting of the panel, seven alternative models for private company financial reporting were discussed. Models based on IFRSs and a model that would have resulted in no change to private company financial reporting were eliminated. All remaining models would result in differences in GAAP for private and public entities; the main focus of the panel moving forward will be to select a model that is relevant to users of private company financial reports because this has become the overriding issue. The three primary models the panel agreed to focus on going forward are U.S. GAAP with Exclusions for Private Companies—with enhancements; U.S. GAAP—Baseline GAAP with Public Company Add-Ons; and Separate, Stand-Alone GAAP Based on Current U.S. GAAP. Most of the panel members also expressed their discontent with the current make-up of FASB and its heavy, but appropriate, focus on public companies. This led to another key discussion topic: the structure of whatever model is chosen—the current FASB; a restructured FASB (with greater private company representation); or a new, separate Private Company Standards Board under the oversight of the Financial Accounting Foundation.

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Recent Pronouncements

.196 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.197 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*,AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and along with SAS No. 119 supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801) Issue Date: December 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 801 to reflect changes in the compliance audit environment and incorporates the risk assessment standards. It requires the auditor to adapt and apply the AU sections of the AICPA's *Professional Standards* to compliance audits and provides guidance on how to do so. It is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.
Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 15, *Audit Evidence* (subject to approval by the Securities and Exchange Commission [SEC]) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard explains what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.
PCAOB Auditing Standard No. 14, *Evaluating Audit Results* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether the auditor has obtained sufficient appropriate audit evidence. The evaluation process set forth in this standard includes, among other things, evaluation of misstatements identified during the audit; the overall presentation of the financial statements, including disclosures; and the potential for management bias in the financial statements.
PCAOB Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements for responding to the risks of material misstatement in financial statements through the general conduct of the audit and performing audit procedures regarding significant accounts and disclosures.
PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. The risk assessment process discussed in the standard includes information-gathering procedures to identify risks and an analysis of the identified risks.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard sets forth requirements for supervision of the audit engagement, including, in particular, supervising the work of engagement team members. It applies to the engagement partner and other engagement team members who assist the engagement partner with supervision.
PCAOB Auditing Standard No. 9, *Audit Planning* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding planning an audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan.
PCAOB Auditing Standard No. 8, *Audit Risk* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance that the financial statements are free of material misstatement.
PCAOB Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards) Issue Date: January 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard and its related amendments supersede the interim concurring partner review requirements and update the interim quality control standards. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB. The standard provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. It is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009.
PCAOB Staff Question and Answer, *Auditing Standard No. 7,* Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10) Issue Date: February 2010	This staff question and answer provides further implementation guidance on the documentation requirements of Auditing Standard No. 7 in light of comments the SEC received during its comment period.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
(Applicable to audits conducted in accordance with PCAOB standards)	
PCAOB Staff Audit Practice Alert (PA) No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06) Issue Date: July 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert is intended to remind registered public accounting firms of their obligations when using the work of other firms or using assistants engaged from outside the firm. The alert was prompted by observations by the PCAOB that a number of registered public accounting firms located within the United States have been issuing reports on financial statements filed by issuers that have substantially all of their operations outside of the United States, and some of these firms may not be conducting those audits in accordance with PCAOB standards.
PCAOB Staff Audit PA No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05) Issue Date: April 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert explains that significant unusual transactions, especially those close to period-end that pose difficult substance over form questions, can provide opportunities for entities to engage in fraudulent financial reporting. This staff audit practice alert is designed to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions.

Recent ASUs

.198 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2010-22, *Accounting for Various Topics—Technical Corrections to SEC Paragraphs (SEC Update)*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board *Accounting Standards Codification*	
Accounting Standards Update (ASU) No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*

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Recent Accounting Standards Updates	
Liabilities Area of FASB ASC	
ASU No. 2009-15 (October 2009)	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2009-13 (October 2009)	*Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
Broad Transactions Area of FASB ASC	
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2009-17 (December 2009)	*Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2009-12 (September 2009)	*Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*
ASU No. 2009-16 (December 2009)	*Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-03 (January 2010)	*Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*

(continued)

Recent Accounting Standards Updates	
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-07 (January 2010)	*Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*
ASU No. 2009-14 (October 2009)	*Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*

Recent Technical Questions and Answers

.199 The following table presents a list of recently issued nonauthoritative audit and attest and accounting technical questions and answers issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssued TechnicalQuestionsand Answers.aspx.

Recent Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
Technical Questions and Answers (TIS) section 1400.33 July 2010	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 July 2010	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 6931.12 July 2010	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 8700.03 June 2010	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9070.06 June 2010	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.23 June 2010	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6140.24 June 2010	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.25 June 2010	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6930.02 June 2010	"Defined Benefit Plan Measurement of a Life Insurance Policy"

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Recent Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
TIS section 5250.14 June 2010	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes "
TIS section 5250.15 June 2010	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 2240.06 June 2010	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.38 June 2010	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 2130.39 June 2010	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.40 June 2010	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 1800.05 June 2010	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments "
TIS section 9110.16 February 2010	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"
TIS section 9150.26 December 2009	"The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements"
TIS section 6910.33 December 2009	"Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination"
TIS section 2220.18 December 2009	"Applicability of Practical Expedient"
TIS section 2220.19 December 2009	"Unit of Account"
TIS section 2220.20 December 2009	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, *Financial Services—Investment Companies*"
TIS section 2220.21 December 2009	"Determining Whether an Adjustment to NAV Is Necessary"
TIS section 2220.22 December 2009	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"
TIS section 2220.23 December 2009	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
TIS section 2220.24 December 2009	"Disclosures—Ability to Redeem Versus Actual Redemption Request"
TIS section 2220.25 December 2009	"Impact of 'Near Term' on Classification Within Fair Value Hierarchy"

(continued)

Recent Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
TIS section 2220.26 December 2009	"Categorization of Investments for Disclosure Purposes"
TIS section 2220.27 December 2009	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
TIS section 8700.01 September 2009	"Effect of FASB ASC 855 on Accounting Guidance in AU Section 560"
TIS section 8700.02 September 2009	"Auditor Responsibilities for Subsequent Events"

Recent AICPA Independence and Ethics Developments

.200 The Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.201 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3, "Performance of Nonattest Services." under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05). Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. The PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as "maintaining internal control" for the client. For example, bookkeeping is recognized to be part of COSO's information and communication element of internal control. Additionally, some nonattest activities, such as performing calculations (for example, tax provision, leases, last in first out [LIFO] reserve); maintaining ledgers (for example, fixed asset ledger); performing reconciliations; and identifying adjusting journal entries, have been viewed as maintaining the client's controls regardless of whether management has met the general requirements of Interpretation No. 101-3 (that is, oversees the service, reviews and approves the work, and makes all significant judgments and decisions).

.202 To address the possible inconsistency in Interpretation No. 101-3, the PEEC is considering possible clarifying revisions to Interpretation No. 101-3, and accordingly, readers are encouraged to monitor the progress of this project.

.203 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

.204 Exposure drafts issued by the PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

On the Horizon

.205 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects

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that are of particular significance or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.206 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.207 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the ISAs issued by the IAASB. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the first half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU sections 341 and 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

.208 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Interim Financial Information

.209 In July 2010, the ASB issued two proposed SASs on interim financial information. The first, *Revised Applicability of Statement on Auditing Standards No. 116*, Interim Financial Information, is intended to revise paragraph 5 of SAS No. 116, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), so that the guidance in SAS No. 116 would be applicable when the auditor audited the entity's latest annual financial statements and the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. Currently, the guidance in SAS No. 116 is applicable when the auditor performs the audit of the latest annual financial statements and expects to be engaged to audit the current year financial statements (and, therefore, is not applicable when the auditor expects that a new auditor may be engaged for the current year). This proposed amendment would be effective for interim reviews of interim financial information for periods beginning after December 15, 2011, with early implementation permitted. Comments are due by October 8, 2010.

.210 The second proposal on interim financial information, *Interim Financial Information* (Redrafted), would supersede SAS No. 116 and represents the redrafting of the guidance to apply clarity drafting conventions. The main changes to existing standards are as follows:

- Replacement of the term *accountant* with *auditor*
- The change to paragraph 5 discussed in the prior paragraph
- Requirement of the auditor to issue a written report unless the review of the interim financial information is required by a third party and the third party does not require a written review report
- Allowance of oral reports for entities that are subject to external requirements to report in a manner that is substantially similar to the reporting required of issuers, pursuant to PCAOB standards
- Requirement for the auditor to perform procedures consistent with those required for acceptance of an engagement to audit financial statements
- Requirement for the review report to include a statement that the review of interim financial information was conducted in accordance with auditing standards generally accepted in the United States of America

.211 This proposed SAS would be effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2012. Comments for this proposed SAS are also due by October 8, 2010.

Finalized Clarified SAS on Service Organizations

.212 As discussed in the "Service Organizations" section of this alert, the ASB released the finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, which will supersede SAS No. 70 upon its effective date. This SAS, along with the majority of other clarified auditing standards, will be effective for periods ending on or after December 15, 2012. This SAS addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. The SAS defines a *service auditor* as a practitioner who reports on controls at a service organization and a *user auditor* as an auditor who audits and reports on the financial statements of a user entity. Services provided by a service organization are relevant to the audit of a user entity's financial statements when those services and the controls over them affect the user entity's information system, including related business processes, relevant to financial reporting. The nature and extent of work to be performed by the user auditor regarding the services provided by a service organization depend on the nature and significance of those services to the user entity and the relevance of those services to the audit. The objectives of the user auditor, when the user entity uses the services of a service organization, are to

- obtain an understanding of the nature and significance of the services provided by the service organization and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement.
- design and perform audit procedures responsive to those risks.

.213 If the user auditor is unable to obtain a sufficient understanding of the service organization from the user entity, among other options, the auditor may obtain that understanding by obtaining and reading a type 1 or type 2 report, if available. A type 1 report is also referred to as a *report on management's description of a service organization's system and the suitability of the design of controls* and comprises the following: (*a*) management's description of the service organization's system; (*b*) a written assertion by management of the service organization about whether, in all material respects and based on suitable criteria, management's description of the service organization's system fairly presents the service organization's system that was designed and implemented as of a specified date and the controls related to the control objectives stated in management's description of the service organization's system were suitably designed to achieve those control objectives as of the specified date; and (*c*) a service auditor's report that expresses an opinion on the matters in (*b*).

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.214 A type 2 report is referred to as a *report on management's description of a service organization's system and the suitability of the design and operating effectiveness of controls*. A type 2 report contains all the same information as a type 1 report except that in the assertion by management of the service organization, the description of the system and its related controls cover a specified period (as opposed to a specified date). A type 2 report also requires management of the service organization to include in their assertion whether the controls related to the control objectives stated in management's description of the service organization's system operated effectively throughout the specified period to achieve those control objectives. Lastly, in a type 2 report, the service auditor's report includes an opinion on the same matters in a type 1 report, plus whether the controls related to the control objectives operated effectively throughout the specified period and a description of the service auditor's tests of controls and the results thereof.

.215 All final clarified SASs can be accessed through the AICPA's website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx. Guidance for service auditors is contained in the recently issued SSAE No. 16.

Exposure Drafts on Auditor's Reports

.216 The ASB issued three proposed SASs related to auditor's reports: *Forming an Opinion and Reporting on Financial Statements*, *Modifications to the Opinion in the Independent Auditor's Report*, and *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. These proposed standards are drafted with the ASB's clarity drafting conventions and are intended to converge with ISAs. The intent of issuing three separate SASs is to assist practitioners in identifying and applying the reporting requirements and guidance. The ASB has made various changes to the related ISAs to tailor them to the United States; however, these changes have not been substantial in nature.

.217 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Exposure Drafts on Special Considerations Audits

.218 Another exposure draft issued by the ASB contains two proposed SASs: *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* and *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. These proposed standards have been drafted with the clarity drafting conventions and are intended to converge with the equivalent ISAs. No meaningful differences exist between these proposed standards and the ISAs. *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* addresses the application of GAAS to financial statements prepared under the cash, tax, regulatory, or contractual bases of accounting. It also replaces the term *other comprehensive basis of accounting* with *special purpose framework*.

.219 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* introduces new planning, performance, and reporting requirements for these engagements. The proposed SAS also clarifies that a single financial statement and a specific element of a financial statement include the related notes.

.220 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Auditing and Attestation Pipeline—Issuers

Confirmations

.221 The PCAOB has proposed a draft of an auditing standard on confirmations. A concept release was originally issued in April 2009 and received 24 comment letters. This proposed auditing standard, issued in July 2010, would strengthen the requirements under the current auditing standard, AU section 330, *The Confirmation Process* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and replace it, upon final issuance of a standard and approval from the SEC. The proposed new standard

- requires confirmation procedures for specific accounts, such as receivables that arise from credit sales, loans, or other transactions, and also in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.
- incorporates procedures in response to the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating nonresponses to confirmation requests.
- updates the confirmation guidance to reflect significant advances in technology and explains that confirmation responses received electronically (for example, by fax e-mail, through an intermediary, or direct access) might involve additional risks relating to reliability. Therefore, the auditor must perform additional requirements.
- defines a confirmation response to include electronic or other medium.
- enhances requirements when confirmation responses include disclaimers and restrictive language by requiring the auditor to evaluate the effect on the reliability of a confirmation response. Further, if the disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

.222 In drafting this proposed standard, the PCAOB considered the guidance contained in ISA 505, *External Confirmations*, and the AICPA's proposed guidance on confirmations. This standard is anticipated to be effective for auditors for fiscal years ending on or after December 15, 2011.

Communications With Audit Committees

.223 In March 2010, the PCAOB proposed for comment an auditing standard on *Communications with Audit Committees* and a series of related amendments to its interim standards that are intended to (*a*) enhance the relevance and effectiveness of the communications between the auditor and the audit committee and (*b*) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. Two of the new requirements would be for the auditor (*a*) to establish a mutual understanding of the terms of the audit engagement with the audit committee and to document that understanding in the engagement letter and (*b*) to evaluate the adequacy of two-way communication between the auditor and audit committee. Additionally, the proposal also includes requirements for the auditor to communicate with the audit committee regarding the following:

- An overview of the audit strategy and timing of the audit, including a discussion of significant risks; the use of the internal audit function; and the roles, responsibilities, and location of firms participating in the audit
- Critical accounting policies, practices, and estimates
- The auditor's evaluation of the entity's ability to continue as a going concern

.224 The proposed standard would become effective, subject to SEC approval, for audits of fiscal years beginning after December 15, 2010.

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Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.225 FASB expects 2010 to be a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. Most recently, FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Other MoU projects
- Other joint projects

.226 A progress report for the quarter ended March 31, 2010, highlighted the following topics: (*a*) on the financial instruments and insurance contracts topics, the boards have reached different conclusions on significant technical issues that may affect the project timetables of these topics; and (*b*) the boards agreed to explore an alternative approach to lessor accounting that may affect the project timetable of this topic. FASB and the IASB also have several other joint projects in process, including balance sheet—offsetting, emissions trading schemes, and reporting discontinued operations. In March 2010, the exposure draft *Conceptual Framework for Financial Reporting* was published for public comment. In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. Specifically, the boards were scheduled to expose for comment numerous major exposure drafts during the second quarter of 2010, and stakeholders voiced concern about their ability under those circumstances to provide high-quality input. The boards have developed a modified strategy to accommodate these concerns by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate consultation document seeking stakeholder input about effective dates and transition methods.

.227 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. The boards also decided to issue separate exposure drafts to address differences in the two sets of standards on balance sheet netting of derivative contracts and other financial instruments. The IASB has also made its projects on improved disclosures about derecognized assets and other off balance sheet risks, consolidations, and insurance contracts priorities. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, have been extended into the second half of 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively affect the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the U.S. financial system.

.228 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Comprehensive Income Exposure Draft

.229 In May 2010, FASB issued a proposed ASU on comprehensive income that would require an entity to report total comprehensive income in a continuous financial statement in two parts: net income and other comprehensive income. In that financial statement, the components of net income and the components of other comprehensive income should be displayed. The proposed ASU is intended to simplify how comprehensive income is reported by eliminating two options for how items of comprehensive income are displayed. The proposed ASU contains illustrative examples of the revised financial statement. This proposed ASU is the result of a joint project as part of IFRSs and U.S. GAAP convergence, and the IASB has separately issued a similar document. The proposed amendments would be applied on a fully retrospective basis to improve comparability between reporting periods. Further, because compliance with the proposed amendments is already permitted, early adoption would be permitted. FASB plans to align the effective date with the effective date of the amendments in the proposed ASU on financial instruments. The IASB and FASB aim to finalize an improved and converged standard on other comprehensive income in the fourth quarter of 2010.

Financial Instruments Exposure Draft

.230 Also, in May 2010, FASB issued a proposed ASU on accounting for financial instruments, derivative instruments, and hedging activities. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments; removes the threshold for recognizing credit impairments, creating a single credit impairment model for both loans and debt securities; and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.
- Changes in fair value of equity securities, certain hybrid instruments, and financial instruments that can be prepaid in such a way that the holder would not recover substantially all of its investment would be recognized in net income each reporting period regardless of an entity's business strategy for those financial instruments.
- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, a reconciliation from amortized cost to fair value would be required on the statement of position; with the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period. Therefore, net income will remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period.
- The existing probable threshold for recognizing impairments on loans would be removed. (Currently, FASB ASC 310-10-35-4 states that the concept in U.S. GAAP is that impairment of receivables [including loans] should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. *Probable* is defined by FASB ASC 310-10-20 as when the future event or events are likely to occur.)

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- For changes in the value of financial instruments measured through other comprehensive income, an entity is required to determine if a credit impairment is appropriate at the end of each reporting period based on information related to past events and existing economic conditions. An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts the entity does not expect to collect.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected, which would better reflect a financial instrument's interest yield.
- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.
- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.231 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments). This proposed ASU was not issued jointly with the IASB and does not contain converged guidance; however, the goal still remains for both boards to issue comprehensive improvements to foster international comparability of financial information about financial instruments. The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009. The IASB also issued two exposure drafts on amortized cost and impairment and fair value option for financial liabilities in late 2009 and mid-2010, respectively; the third topic, hedge accounting, is still being deliberated by the IASB, and an exposure draft is expected in the near term. The boards have stated that they will consider together the comment letters and other feedback received on each boards' exposure drafts in an effort to reconcile their differences in ways that foster improvement and convergence. A comparison of FASB and IASB proposed models for financial instruments as of May 2010 can be found on FASB's website. The effective date of these amendments will be established upon issuance of the final ASU, which is expected in the second quarter of 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional 4 years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

Revenue Recognition Exposure Draft

.232 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from Contracts with Customers*, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.233 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities (for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (*performance obligation* is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).
- determine the transaction price (*transaction price* is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.234 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*) recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

.235 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the boards plan to invite additional comment through a separate consultation on how best to transition over to the new standards. Therefore, no expected specific effective date is stated at this point. Comments on the exposure draft are due on October 22, 2010. This topic is considered by many to be the most pervasive of any FASB has ever worked on. The reader is encouraged to review the exposure draft, consider if it is operational to you or your clients' common revenue transactions, and share any resulting concerns with FASB. The boards also anticipate holding public roundtable meetings after the end of the comment period.

Fair Value Exposure Draft

.236 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

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- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.237 The first two of these significant amendments are intended to clarify the application of existing fair value measurement guidance. The last three of these significant amendments would change a particular principle of fair value guidance.

.238 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines *highest and best use* as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values do not depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.239 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

.240 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to interest rate risk, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice. However, they might affect the current practice for reporting entities that apply the in-use valuation premise more broadly.

.241 The proposed amendments regarding the application of blockage factors and other premiums and discounts in fair value measurements would make two changes to current guidance. Currently, under U.S. GAAP, use of a blockage factor in fair value measurements is only prohibited when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). This would be level 1 within the fair value hierarchy. The first change from the proposed amendments is that a blockage factor is not relevant and, therefore, also should not be used when fair value is measured using a valuation technique that does not use a quoted price. This would be level 2 or level 3 within the fair value hierarchy. Second, the amendments specify that fair value measurements categorized within level 2 and level 3 take into account other premiums

and discounts when market participants would consider those premiums or discounts when pricing an asset or a liability, consistent with the unit of account for that asset or liability. Examples include a control premium or a noncontrolling interest discount. These proposed amendments may affect current practice for any reporting entities applying a blockage factor in fair value measurements that is measured using quoted prices and categorized within level 2 of the fair value hierarchy.

.242 Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

- The effect on a fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances
- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use
- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

.243 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs.

Financial Statement Presentation Staff Draft

.244 FASB and the IASB are working together to establish a common standard that would improve how information is organized and presented in financial statements. This common standard is intended to address users' concerns that existing requirements permit too many alternative types of presentation and that information in financial statements is highly aggregated and inconsistently presented, making it difficult to understand fully the relationship between an entity's financial statements and its financial results. In 2008, a discussion paper was issued by the boards that outlined the proposed principles for presenting financial statements in a way that portrays a cohesive financial picture of an entity.

.245 Given the magnitude of this project, the expected implementation costs, and the substantial effects it will have on financial statement presentation for many years to come, the boards decided in May 2010 to modify the strategy for this project. Before finalizing an exposure draft, the boards decided to engage in additional outreach activities that focus on the perceived benefits and costs of the proposals and the implications of the proposals for financial reporting by financial service entities. The boards plan on discussing these two areas of focus with preparers and users of financial statements. This outreach will be based on a rough draft of a proposed standard, known as a *staff draft*, and reflects the cumulative tentative decisions made by the boards, concluding with their joint meeting in April 2010. This staff draft was made publicly available solely for this purpose.

.246 The proposals in this project would be applicable to all entities, except a benefit plan within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, 962, *Plan Accounting—Defined Contribution Pension Plans*, and 965, *Plan Accounting—Health and Welfare Benefit Plans* or IAS 26, *Accounting and Reporting by Retirement Benefit Plans*. The two core financial statement principles in this proposal are cohesiveness and disaggregation. A common structure for the statements of financial position, comprehensive income, and cash flows would be established in the form of required sections, categories or subcategory, and related subtotals. Some proposed specific changes in the classification and format of financial statements include the following:

- Related information would be displayed in the same sections, categories, and subcategory in each statement so that information is more easily associated.

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- Presentation of business and financing activities would be separated as follows:
  - The business section would include items that are part of an entity's daily operations and other income-generating activities.
  - The financing section would include items that are part of an entity's activities to obtain (or repay) capital.
- Discontinued operations and income taxes would be presented in their own separate sections.
- The statement of changes in equity would not include the sections and categories used in the other statements because that statement presents information solely about changes in items classified in the equity category in the statement of financial position.

.247 Further, FASB plans to propose some changes that are already required by IAS 1, *Presentation of Financial Statements*. The proposal would define, and provide the requirements for, a complete set of financial statements. Currently, a complete set of financial statements for the period is defined only in the FASB Concepts Statements. An entity would also be required to present one period of comparative information. A *complete set of financial statements* would consist of, at a minimum, statements of financial position, comprehensive income, cash flows and changes in equity, and notes to financial statements for two periods (the current period and the previous period). Also, an opening statement of financial position would be part of a complete set of financial statements if an entity applies an accounting principle retrospectively, restates its financial statements, or reclassifies items in the financial statements.

.248 The boards' tentative decisions on financial statement presentations do differ in a few ways in relation to minimum line requirements for the statement of financial position, segment reporting, and net debt presentation. Of these three, the differing stance on segment reporting is the only significant difference. The boards now aim to issue an exposure draft in the first quarter of 2011 and a final improved and converged standard in the fourth quarter of 2011. Both the introduction to the staff draft and the staff draft can be accessed from FASB's website at www.fasb.org.

Leases Exposure Draft

.249 During the third quarter of 2010, the IASB and FASB published for public comment joint proposals to improve the financial reporting of lease contracts. These proposals would result in a consistent approach to lease accounting for both lessees and lessors—a "right of use" approach. This would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, therefore providing more complete and useful information to investors and other users of financial statements. Currently, the accounting for a lease depends on its classification; an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRSs or U.S. GAAP, whereas a capital lease results in the lessee recognizing an asset and an obligation. Under the proposed guidance, lessees would only have one method of accounting for leases, which would produce more complete and comparable financial reporting in addition to reducing the opportunity to structure transactions to achieve a desired accounting outcome.

.250 The scope of the new lease guidance includes all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. Under this new guidance, all lessees would use a single method of accounting for all leases: an asset would be recognized representing the lessee's right to use the leased (underlying) asset for the lease term (the right-of-use asset), and a liability at the present value of the expected lease payments would also be recognized.

.251 A lessor would recognize an asset representing its right to receive lease payments, and depending on its exposure to risks or benefits associated with the underlying asset, the lessor would either (*a*) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach) or (*b*) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual

asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach). The assets and liabilities recognized by both lessors and lessees would be measured on the basis that

- assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- a remeasurement is triggered when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

.252 For leases of 12 months or less, lessors and lessees would be able to apply simplified requirements. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. New disclosures would also be required.

.253 In early 2009, the boards issued a discussion paper on leases; this exposure draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors, regulators, and other interested parties since that discussion paper. The comment period is open until December 15, 2010. During the comment period, the boards will undertake further outreach activities, including public roundtable meetings to ensure that the views of all interested parties are taken into consideration before the new standard is completed. Also, the boards will share and jointly consider all comment letters received. A final standard is expected in 2011.

Auditing Considerations of Accounting Convergence

.254 Although the future of convergence between IASB and FASB accounting standards remains an unknown, discussions have already begun about the potential impact on auditors. Although auditors are accustomed to new standards, the nature and volume of these changes will likely pose new challenges. Among others, some of these potential challenges include the following:

- Training audit staff on a large amount of new accounting guidance that is based on an accounting approach (that is, principles based versus rules based)
- Developing, as necessary, any new internal audit guidance, such as firm methodology
- Implementing any new resulting auditing rules
- Creating a new framework for documenting audit conclusions on a principles-based accounting approach
- Audit committees learning new accounting guidance to effectively perform their function

.255 In addition to the challenges auditors will face, the effects on preparers will also be great. At the time of this writing, it appears that the transition timeline to convergence will be relatively short; this will divert resources during the preparation of financial statements as entities focus on implementing the new principles, which may result in increased audit risk. Auditors, in addition to preparers, are also encouraged to remain current on developments of international accounting convergence.

FASB Accounting Pipeline

Disclosure of Certain Loss Contingencies

.256 In July 2010, FASB issued an exposure draft on the disclosure of certain loss contingencies in response to concerns from investors and other financial statement users that the current disclosures do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. The objective of these disclosures would be for an entity to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to

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understand all of the following: the nature of the loss contingencies, their potential magnitude, and their potential timing (if known). Disclosure of certain remote loss contingencies would be required and, therefore, would expand the population of loss contingencies that are required to be disclosed. An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required. Further, current qualitative disclosures would be enhanced by requiring additional disclosures. These additional required qualitative and quantitative disclosures include the following:

- For litigation contingencies, the contentions of the parties and how users can obtain more information about the litigation
- Publicly available quantitative information, such as the claim amount for asserted litigation contingencies; other relevant nonprivileged information; and, in some cases, information about possible recoveries from insurance and other sources
- For public entities, tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the period

.257 The amendments in this proposal would affect all entities. The exposure draft noted that FASB will continue to work with the PCAOB, the AICPA, and the American Bar Association (ABA) to identify and address any potential implications of the proposed amendments for auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The proposed amendments would be effective for fiscal years ending after December 15, 2010, for public entities and in the first annual period beginning after December 15, 2010, for nonpublic entities. The comment period ended in September 2010.

Going Concern FASB Project

.258 Currently, the only guidance on going concern resides in the auditing literature, and this project's intention is to incorporate going concern guidance into U.S. GAAP. Specifically, this guidance would discuss the following:

- Preparation of financial statements as a going concern
- An entity's responsibility to evaluate its ability to continue as a going concern
- Disclosure requirements when financial statements are not prepared on a going concern basis
- Disclosure requirements when there is a substantial doubt about an entity's ability to continue as a going concern
- The adoption and application of the liquidation basis of accounting

.259 A revised exposure draft is expected to be issued in the fourth quarter of 2010, with a final ASU expected in the first quarter of 2011. FASB has decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Readers should be alert to developments on this topic.

Other Accounting Projects

.260 Additionally, FASB has the following projects underway:

- Troubled debt restructuring
- Disclosure framework
- Investment properties

Resource Central

.261 The following are various resources that practitioners may find beneficial.

Publications

.262 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Guide *Compilation and Review Engagements* (2010) (product no. 0128110 [paperback] or WRC-XX [online])
- Audit Guide *Auditing Revenue in Certain Industries* (2010) (product no. 0125110 [paperback] or WAR-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2010/11* (product no. 0223010 [paperback])
- Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709 [paperback] or WIA-XX [online])
- *Independence Library* featuring the Audit Risk Alert *Independence and Ethics Developments—2009* and two independence practice aids (product no. WIL-XX [online])
- *Checklists and Illustrative Financial Statements for Corporations* (product no. 008939 [paperback] or WCP-CL [online])
- *Accounting Trends & Techniques, 63rd Edition* (product no. 0099009 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099109 [paperback] or WIF-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Audit and Accounting Practice Aid *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006661 [paperback] or WGO-XX [online])
- Audit and Accounting Practice Aid *Independence Compliance: Checklists and Tools for Complying With AICPA, SEC, and PCAOB Independence Requirements* (product no. 006660 [paperback] or WSC-XX [online])
- Financial Reporting Alert *Current Economic Crisis: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

AICPA Online Professional Library: Accounting and Auditing Literature

.263 The AICPA has created your core accounting and auditing library online. AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification™*, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC on Online Professional Library (product no. WFA-XX [online]). To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

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Continuing Professional Education

.264 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop (2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Strong Foundation* (product no. 741602 [text], 181601 [DVD/Manual], or 351601 [Additional Manual for DVD]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

.265 Visit www.cpa2biz.com for a complete list of CPE courses.

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- Fair Value Accounting
- Accounting for Goodwill and Other Intangibles
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- Revenue Recognition in Today's Business Climate
- International Versus US Accounting
- Fraud and the Financial Statement Audit
- Public Company Update
- SEC Reporting

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Accounting and Auditing Technical Hotline

.270 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.271 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

The CAQ

.272 The CAQ, which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.273 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit http://thecaq.aicpa.org.

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	http://www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FinREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org

(continued)

Website Name	*Content*	*Website*
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov

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AAM Section 8015

Compilation and Review Developments—2010/11

STRENGTHENING ENGAGEMENT QUALITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Compilation and Review Alert replaces *Compilation and ReviewDevelopments—2009*.

This Compilation and Review Alert (alert) is intended to provide accountants with an update on recent practice issues and professional standards that affect compilation and review engagements. This alert also can be used by an entity's internal management to address areas of concern.

This publication is an *other compilation and review publication*, as defined in AR section 50, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2).[1] Other compilation and review publications have no authoritative status; however, they may help the accountant understand and apply Statements on Standards for Accounting and Review Services.

If an accountant applies the guidance included in an other compilation and review publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the engagement and appropriate. The guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully appreciates the invaluable assistance Kristy L. Illuzzi, CPA, and Dennis W. Ridge, Jr., CPA, provided in creating this publication. The AICPA would like to thank the members of the Accounting and Review Services Committee for their invaluable review of this year's publication. We would also like to thank Michael P. Glynn, CPA, technical manager, Audit and Attest Standards, for his essential contributions in creating this publication.

Feedback

The *Compilation and Review Developments* alert is published annually. As you encounter issues that you believe warrant discussion in next year's alert, please feel free to share them with us. Any other comments that you have about the alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Compilation and Review Alert (alert) helps you plan and perform your compilation and review engagements and can be used by an entity's internal management to address areas of concern. This alert discusses recent Statements on Standards for Accounting and Review Services (SSARSs) developments,

[1] In December 2009, the Accounting and Review Services Committee issued Statement on Standards for Accounting and Review Services (SSARS) No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). Upon becoming effective, this new standard will supersede AR section 50, *Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2). However, SSARS No. 19 retains essentially the same guidance on interpretive publications as currently exists in AR section 50. SSARS No. 19 is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010.

addresses emerging practice issues, and provides valuable information regarding current accounting developments. You should refer to the full text of accounting and compilation and review pronouncements, as well as the full text of any rules or publications that are discussed in this alert.

Economic Developments

The Current Economy

.02 When planning and performing compilation and review engagements, the accountant should understand both the general current economy and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

.03 The year 2010 may be the beginning of a wave of economic recovery. Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. Further, after experiencing a considerable decline in the stock market through March 2009, the markets have rebounded substantially. In March 2009, the S&P 500 and the Dow Jones Industrial Average reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002. By March 2010, only a year later, all 3 had increased in value by at least 59 percent from the previous year's lows. However, all 3 remained unmoved 4 months later, in July 2010. This exhibits the continuing uncertainty in the markets due to the varying economic indicators, the financial reform regulatory changes, and Europe's economy, among other reasons.

Key Economic Indicators

.04 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.05 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.6 percent in the second quarter of 2010 (second estimate), 3.7 percent in the first quarter of 2010, and 5.6 percent in the fourth quarter of 2009. This data indicates a turnaround in the economy because in the fourth quarter of 2008 and the first quarter of 2009, real GDP decreased 6.3 percent and 5.5 percent, respectively. Further, in June 2010, the Treasury reported that banks had repaid about 75 percent of the bailout money they received through the Troubled Asset Relief Program and that taxpayers made $21 billion on the investment. However, other bailouts are not yet repaid, and they may yield losses to taxpayers.

.06 From July 2009 to July 2010, the unemployment rate fluctuated between 9.4 percent and 10.1 percent. An unemployment rate of 10.0 percent represents approximately 15.3 million people. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. However, through June 2010, the rate has remained below 10.0 percent. Additionally, one reason for the continued high unemployment rate is that more Americans are resuming their search for work.

.07 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent, where it remained through early August 2010. The Federal Reserve described the current economic recovery in its August 10, 2010, press release as follows:

- Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software is rising; however, investment in nonresidential structures continues to be weak and employers remain reluctant to add to payrolls.

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- Housing starts remain at a depressed level.
- Bank lending has continued to contract in recent months.
- The pace of economic recovery is expected to be more modest in the near term than had been anticipated.

.08 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant their holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the economic crisis, the Federal Reserve's balance sheet has grown to $2.3 trillion. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

Small Business Trends and Conditions

.09 Private companies and, more specifically, small businesses are a main driver for the U.S. economy. According to the National Federation of Independent Businesses (NFIB), small businesses have produced roughly half of the private GDP and approximately 2 out of every 3 net new jobs in the United States since the early 1970s. Businesses employing less than 100 people constitute 96 percent of all employers.

.10 According to the July 2010 *NFIB Small Business Economic Trends*, the June Index of Small Business Optimism lost 1 point over the previous month, falling to 87.9, after posting a gain of 6.9 points since March 2010. Four of the 10 index components posted gains, but 6 lost ground. The decline, although small in magnitude, was primarily a result of declines in expected real sales and expected business conditions.

.11 In summary, the economic outlook remains uncertain. Pay close attention to how economic factors, such as interest rates, consumer confidence, the housing market, overall economic expansion or contraction, inflation, and the labor market, will affect your clients and your compilation and review engagements.

Legislative and Regulatory Developments

The Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act

.12 In March 2010, the president signed into law a sweeping overhaul of the health care system. Almost everyone in the United States will be affected by these changes—individuals, insurance companies, health care providers, and employers. The three primary goals of the reform are to expand coverage to those without health insurance, reform the delivery system of benefits to improve quality, and decrease the costs of providing health care. The various provisions of the reform will become effective over time, through 2020. The new laws contain many changes for employers to consider for financial reporting purposes, in addition to many new tax rules to help offset the overall cost of the reform.

.13 The complete changes are contained in two acts. The Health Care and Education Reconciliation Act of 2010 was signed on March 30 and is a reconciliation bill that amends the Patient Protection and Affordable Care Act signed into law by the president one week earlier. In April, the Securities and Exchange Commission (SEC) issued a staff announcement, *Accounting for the Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act*, to address questions that have arisen about the effect, if any, that the different signing dates might have on accounting for the two acts. This timing difference, related solely to the signing dates, should not have an impact on a majority of registrants because the acts were both signed within a relatively short time period, which for the vast majority of entities, falls into the same reporting period. However, there may be a limited number of registrants with a period-end that falls between the signing dates for which the timing difference could raise questions about whether the different signing dates have an accounting impact.

.14 After consultation with the Financial Accounting Standards Board (FASB) staff, the Office of the Chief Accountant would not object to a view that the two acts should be considered together for accounting purposes. That is, in this specific fact pattern, the SEC staff would not object to a registrant incorporating the effects of the Health Care and Education Reconciliation Act of 2010 when accounting for the Patient Protection and Affordable Care Act. This view is based in part on the SEC staff's understanding that the two acts, when taken together, represent the current health care reform as passed by Congress and signed by the president. The SEC staff does not believe that it would be appropriate to analogize to this view in any other fact patterns.

Significant Accounting and Tax Considerations

.15 FASB *Accounting Standards Codification* (ASC) 740-10-30-2 states that the following basic requirements are applied to the measurement of current and deferred income taxes at the date of the financial statements:

- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

.16 FASB ASC 715-60-35-102 further explains that benefit coverage for medical claims by governmental programs or other providers of health care benefits should be assumed to continue as provided by the present law and other providers, pursuant to their present plans. Consistent with FASB ASC guidance, presently enacted changes in the law or amendments of the plans of other health care providers that take effect in future periods and that will affect the future level of their benefit coverage should be considered in current period measurements for benefits expected to be provided in those future periods. Future changes in laws concerning medical costs covered by governmental programs and future changes in the plans of other providers should not be anticipated.

.17 The two primary accounting considerations resulting from this reform are the effects of the tax law changes on deferred income tax balances and other postretirement health benefits. One of the most significant changes relates to the government subsidy for providing qualifying prescription drug coverage to Medicare-eligible retirees becoming an offset for prescription drug income tax deductions. Specifically, because entities will need to reduce their income tax deduction for providing prescription drug coverage by the subsidy received, they currently need to record a charge to earnings to write off a portion of their deferred tax assets related to postretirement health care obligations. Such deferred tax assets were based on the gross liability amount. Because the tax deductible prescription drug costs liability will be reduced by the subsidy, the deferred tax asset will be computed net of the subsidy, resulting in a lower deferred tax asset. The federal subsidy will not reduce the tax deductions until 2013. Even though the changes may not be effective until future periods, the effects are accounted for in the period that includes the enactment date. FASB ASC 715-60 discusses accounting and reporting guidance for other postretirement plans, including the Medicare prescription drug plan. Many public entities have already posted large noncash charges in early 2010 related to the nondeductibility of the subsidy.

.18 Some of the other provisions of the reform that may affect an entity's tax position include the nondeductible pharmaceuticals fee, the medical device excise tax, and the therapeutic discovery project tax credit, which will have an effect on the pharmaceutical and medical device industries. Additionally, employer group health plans may not impose lifetime limits and can only impose "restricted" annual limits beginning with the 2011 plan year (for calendar year plans); no annual limits would be permitted beginning in 2014. Because these health benefits can no longer be limited, entities may need to increase accruals for future medical obligations. Many small businesses and tax-exempt organizations that provide health insurance coverage to their employees will now qualify for a special tax credit that is designed to encourage small employers to offer health care coverage for the first time or maintain the coverage they have. Lastly, under the new reform, a 40 percent penalty will apply to tax understatements attributable to transactions lacking economic substance (20 percent with adequate disclosure) or failing to meet the requirements of any similar rule of law. A transaction is treated as having economic substance only if the transaction changes in a

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meaningful way (apart from federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

.19 The full text of these acts can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ152.111.pdf and http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ148.111.pdf. Readers are also encouraged to refer to the Audit Risk Alerts *Health Care Entities—2010/11* (product no. 0223410) and *Not-for-Profit Entities—2010* (product no. 0224210).

Recently Issued SSARS

Issuance of SSARS No. 19

.20 In December 2009, the Accounting and Review Services Committee (ARSC) issued SSARS No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). The standard's effective date is for periods ending on or after December 15, 2010, with the exception of paragraph 2.21 (AR sec. 80 par. .21), which may be implemented early. Paragraph 2.21 (AR sec. 80 par. .21) states in part, "The accountant is not precluded from disclosing a description about the reason(s) that his or her independence is impaired." See appendix B, "Significant Change to Compilation Reporting Requirements When Independence Is Impaired," of this alert for questions and answers regarding this new independence reporting option. It should be noted that SSARS No. 19 does not change the independence literature in any way—it just provides a reporting option for accountants performing compilation engagements.

.21 Another significant change that smaller firms should appreciate is that this new standard separates the compilation guidance from the review guidance. Other significant changes to SSARSs included the following:

- A discussion of how the accountant obtains limited assurance through the performance of review procedures
- The introduction of the term *review evidence* to the review literature
- A discussion of tailoring the review procedures based on the accountant's understanding of the client's industry, knowledge of the client, and awareness of the risk that the accountant may unknowingly fail to modify his or her review report on financial statements that are materially misstated
- A discussion of materiality in the context of a review engagement
- A requirement that an accountant document the establishment of an understanding with management through a written communication (that is, an engagement letter) regarding the services to be performed
- The establishment of enhanced documentation requirements for compilation and review engagements

.22 The final standard differs from the exposure draft in two major ways:

- First, ARSC decided to retain the concept of limited assurance rather than moderate assurance. ARSC proposed to use the term *moderate assurance* to describe the level of assurance that the accountant aims to obtain in a review engagement in order to harmonize with the terminology used in the international review standards. However, after the exposure draft was issued, the International Auditing and Assurance Standards Board (IAASB) began looking to revise the international review standard from moderate to limited.
- The other major difference is that the nonindependent review is not part of the final standard. ARSC received a number of comments on this proposal, both for and against. As a result of the great interest in this topic, ARSC decided it made the most sense to defer this issue so it could hold additional meetings with key stakeholders. These additional meetings will be used to further discuss with stakeholders the issues that many smaller firm members face in trying to serve their small business clients and to better understand why some stakeholders are opposed to the nonindependent review

concept. The focus of the issues deal with the ARSC proposal that would have permitted an accountant to provide a review service while also performing a nonattest service to help smaller businesses maintain aspects of their internal control over financial reporting, the purpose of which is to improve the reliability of the client's financial statements.

.23 Although the nonindependent review is not part of SSARS No. 19, ARSC remains committed to allowing practitioners to review financial statements when they also perform services that are intended to assist the client in preparing high-quality, reliable financial statements.

.24 To assist practitioners with understanding and implementing the new guidance contained in SSARS No. 19, the Private Companies Practice Section (PCPS) has developed a SSARS No. 19 toolkit. For additional information on the SSARS No. 19 toolkit, refer to "PCPS SSARS No. 19 Toolkit" section of this alert.

Proposed SSARS

The Applicability of Statements on Standards for Accounting and Review Services

.25 In July 2010, ARSC exposed for public comment a proposed SSARS, *The Applicability of Statements on Standards for Accounting and Review Services*. In February 2009, ARSC issued SSARS No. 18, *Applicability of Statements on Standards for Accounting and Review Services* (AICPA, *Professional Standards*, vol. 2). SSARS No. 18 revised the applicability of SSARSs so that SSARSs do not apply when the provisions of Statement on Auditing Standards (SAS) No. 116, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), apply.

.26 The revisions to SSARSs that were made effective by SSARS No. 18 were included in paragraph 3.1 (AR sec. 90 par. .01) of SSARS No. 19. That paragraph states that SSARSs are not applicable when an auditor performs the audit of the latest annual financial statements and expects to be engaged to audit the current year financial statements. SSARSs are effective when the auditor expects that a new auditor may be appointed for the current year but that such appointment is not yet effective prior to the period covered by the review. The proposed SSARS would revise the review literature to exclude such an engagement from SSARSs; instead, the auditor would follow the requirements and guidance in the proposed SAS *Interim Financial Information* (Revised).

Proposed Statement on Standards for Attestation Engagements

Reporting on Compiled Prospective Financial Statements When Independence Has Been Impaired

.27 In June 2010, ARSC released a proposed Statement on Standards for Attestation Engagements, *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence Is Impaired*. This proposal was done in response to the issuance of SSARS No. 19, which now allows the accountant to disclose the reason(s) for any independence impairments in his or her compilation report. ARSC determined that the attestation standards should also be revised so that the accountant, if he or she chooses, can disclose the reason(s) for an independence impairment in his or her compilation report on prospective financial information.

.28 If issued as a final standard, the standard would result in revisions to AT section 301, *Financial Forecasts and Projections* (AICPA, *Professional Standards*, vol. 1).

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Other Current ARSC Projects

The Use of the Accountant's Name in a Document or Communication Containing Unaudited Financial Statements That Have Not Been Compiled or Reviewed

.29 The Auditing Standards Board (ASB), as part of its auditor's reports project, considered the requirements and guidance in AU section 504, *Association With Financial Statements* (AICPA, *Professional Standards*, vol. 1). The ASB's Auditor's Report Task Force determined that because ARSC is the senior technical committee of the AICPA designated to issue enforceable standards in connection with the unaudited financial statements or other unaudited financial information of a nonissuer, the requirements and guidance related to unaudited financial information should be contained in SSARSs.

.30 The ASB voted to ballot to withdraw AU section 504 at its meeting in August 2010. The relevant guidance with respect to reporting on audited and unaudited financial statements in comparative form is addressed in the proposed SAS *Forming and Opinion and Reporting on Financial Statements*. SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In addition, amendments to other clarified SASs to address the auditor's association with financial statements, as well as to address the situation when the auditor is not independent but is required by law or regulation to perform the audit, resulting from the withdrawal of AU section 504 will be included in a proposed Omnibus SAS that will address all of the amendments necessary at the end of the clarity project.

.31 ARSC is currently considering the requirements and guidance that would apply when the accountant's name is used in a document or communication containing unaudited financial statements that the accountant has not compiled or reviewed.

Compilation and Review of Financial Statements Prepared in Accordance With a Financial Reporting Framework Generally Accepted in Another Country

.32 At its meeting in April 2009, the ASB reconsidered the applicability of AU section 534, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*, vol. 1). Paragraph .08 of AU section 534 states as follows:

> Financial statements prepared in conformity with accounting principles generally accepted in another country ordinarily are not useful to U.S. users. Therefore, if financial statements are needed for use both in another country and within the United States, the auditor may report on two sets of financial statements for the entity—one prepared in conformity with accounting principles generally accepted in another country for use outside the United States, and the other prepared in accordance with accounting principles generally accepted in the United States .... If dual statements are not prepared, or for some other reason the financial statements prepared in conformity with accounting principles generally accepted in another country will have more than limited distribution in the United States, the auditor should report on them using the U.S. standard form of report, modified as appropriate for departures from accounting principles generally accepted in the United States ....

.33 After discussion and input from legal counsel regarding Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01), the ASB concluded to retain the reporting provisions of AU section 534.

.34 As a result of the ASB's decision, the AICPA staff believes that similar reporting provisions should apply to compilations and reviews of financial statements prepared in accordance with a financial reporting framework generally accepted in another country.

Applicability of SSARS No. 19 to Personal Financial Statements

.35 Historically, the authoritative accounting literature on personal financial statements was included in Statement of Position 82-1, *Accounting and Financial Reporting for Personal Financial Statements*. This guidance was subsumed into FASB ASC on July 1, 2009, and now resides in FASB ASC 274, *Personal Financial Statements*.

.36 Accountants are often engaged to compile personal financial statements. The standard report wording contained in SSARS No. 19 includes wording stating the fact that "management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework [and] for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements."

.37 Members have questioned whether the language about "designing, implementing, and maintaining internal control" would be applicable to reports on personal financial statements.

.38 Although individuals usually do not have formal systems of internal control over financial reporting, individuals still need to have controls to permit the preparation of financial statements. An accountant's independence would be impaired if he or she establishes or maintains internal control for a client (see Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* [AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05]). Therefore, the standard report wording is appropriate in engagements to compile or review personal financial statements. The AICPA staff is working on nonauthoritative illustrative reports in order to clarify the appropriate language for reports on compiled or reviewed personal financial statements.

Current Practice Issues

.39 In May 2010, the article "Changes on Tap for Compilation and Review Standards" was published in the AICPA *Journal of Accountancy*. The article was written by Carolyn McNerney, CPA (chair of ARSC); Charles E. Landes, CPA (AICPA vice president of Professional Standards); and Michael P. Glynn, CPA (AICPA Audit and Attest Standards technical manager and staff liaison to ARSC). This article discusses the major changes to compilation and review standards resulting from the issuance of SSARS No. 19 that affect practitioners performing compilations and reviews on financial statements for periods ending on or after December 15, 2010. This article was intended to serve as plain English implementation guidance for SSARS No. 19 and is included as appendix C, "'Changes on Tap for Compilation and Review Standards,'" of this alert.

New Reports for Compilations and Reviews of Financial Statements Ending on or After December 15, 2010

.40 The May 2010 *Journal of Accountancy* article includes a discussion of the revisions to the reporting requirements for compilation and review engagements that are included in SSARS No. 19 to make the reports clearer regarding management's responsibilities and the accountant's responsibility. The following is a comparison of the pre-SSARS No. 19 compilation report with the new report prescribed by SSARS No. 19.

	Pre-SSARS No. 19 Compilation Report	*SSARS No. 19 (New) Compilation Report*
Title	Not required	Accountant's Compilation Report
Addressee	Not required	[*Appropriate Salutation*]

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	Pre-SSARS No. 19 Compilation Report	*SSARS No. 19 (New) Compilation Report*
Introductory paragraph	I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended, in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants.	I (we) have compiled the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. I (we) have not audited or reviewed the accompanying financial statements and, accordingly, do not express an opinion or provide any assurance about whether the financial statements are in accordance with accounting principles generally accepted in the United States of America.
Paragraph outlining management's responsibilities	None	Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of financial statements.
Paragraph outlining the accountant's responsibilities	None	My (our) responsibility is to conduct the compilation in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. The objective of a compilation is to assist management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements.

(continued)

	Pre-SSARS No. 19 Compilation Report	*SSARS No. 19 (New) Compilation Report*
Conclusion paragraph	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 communication is moved to the introductory paragraph.
Paragraph disclosing the independence impairment	I am (we are) not independent with respect to XYZ Company. The accountant is precluded from disclosing the reasons for the independence impairment.	I am (we are) not independent with respect to XYZ Company. The accountant is not precluded from disclosing the reasons for the independence impairment.

.41 The following is a comparison of the pre-SSARS No. 19 review report to the new report prescribed by SSARS No. 19.

	Pre-SSARS No. 19 Review Report	*SSARS No. 19 (New) Review Report*
Title.	Not required	Independent Accountant's Report
Addressee.	Not required	[*Appropriate Salutation*]
Introductory paragraph. In the new report, the scope of the engagement is described (it was included in the second paragraph of the previous review report). Management's responsibilities are moved to a separate paragraph.	I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. All information included in these financial statements is the representation of management (owners) of XYZ Company.	I (We) have reviewed the accompanying balance sheet of XYZ Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. A review includes primarily applying analytical procedures to management's (owners') financial data and making inquiries of company management (owners). A review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole. Accordingly, I (we) do not express such an opinion.

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	Pre-SSARS No. 19 Review Report	*SSARS No. 19 (New) Review Report*
Second paragraph. The new report describes management's responsibilities. The scope of the engagement is included in the introductory paragraph.	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.	Management (owners) is (are) responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America and for designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
Paragraph describing the accountant's responsibilities.	None	My (our) responsibility is to conduct the review in accordance with Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants. Those standards require me (us) to perform procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements. I (We) believe that the results of my (our) procedures provide a reasonable basis for our report.
Paragraph describing the results of the engagement.	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.	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 accounting principles generally accepted in the United States of America.

Preparation of Financial Statements for Use by an Entity's Auditors

.42 In December 2008, ARSC issued Interpretation No. 31, "Preparation of Financial Statements for Use by an Entity's Auditors," of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2, AR sec. 9100 par. .136–.137). The interpretation clarifies that in the situation when a client engages an accountant, other than its auditor, to prepare unaudited financial statements on behalf of management and when those financial statements are provided by management to its outside auditor for the purposes of the annual audit, the client's outside auditor is not deemed to be a third party using the financial statements. As such, the accountant can avail himself or herself of the nonreporting exemption provided when compiled financial statements are not expected to be used by a third party. All of the interpretations of AR section 100 are available at www.aicpa.org/Research/Standards/CompilationReview/DownloadableDocuments/AR-00100_9.pdf.

Current Accounting and Financial Reporting Issues

Other Comprehensive Bases of Accounting Disclosures

.43 Accountants are often requested to compile or review financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP). These bases of accounting are often referred to as an other comprehensive basis of accounting (OCBOA) and include bases such as the income tax basis of accounting and the cash basis of accounting.

.44 A significant challenge in compiling or reviewing financial statements prepared in accordance with an OCBOA is that, unlike GAAP, authoritative guidance, with respect to the form and content of the financial statements, does not exist. However, that does not alleviate the requirement that the financial statements be appropriate in form.

.45 Financial statements prepared in accordance with an OCBOA are not considered appropriate in form unless the financial statements include the following:

a. A description of the OCBOA, including a summary of significant accounting policies and a description of how the OCBOA differs from GAAP, although the effects of the differences need not be quantified

b. Informative disclosures similar to those required by GAAP if the financial statements contain items that are the same as, or similar to, those in financial statements prepared in accordance with GAAP

.46 If the OCBOA financial statements do not include the preceding information, the accountant should modify his or her compilation or review report accordingly to disclose the departure from the OCBOA.

Common Peer Review Findings

.47 In 2008, the AICPA Peer Review Program reported approximately 9,600 peer reviews, of which approximately 5,200 pertained to compilation and review engagements. The importance of the peer review findings cannot be overemphasized. The following is a brief listing of just some of the most recent deficiencies that were encountered:

- Compilation reports that failed to include the paragraph regarding the omission of required disclosures as applicable in the circumstances.
- Compilation reports that do not comply with minimum reporting requirements.
- Issuance of a review report when the accountant is not independent.
- Failure to disclose the lack of independence in a compilation report.
- In an engagement to compile financial statements that omit substantially all disclosures, failure to disclose, in the accountant's compilation report, management's omission of substantially all disclosures.
- The engagement letter in an engagement to compile financial statements that are not expected to be used by a third party did not refer to supplementary information, which was presented along with the basic financial statements.
- Failure to use a work program or a reporting and disclosure checklist when required by firm policy (this is not required by professional standards).
- For review engagements, failure to perform analytical and inquiry procedures and failure to adequately document the procedures.
- For review engagements, failure to obtain a client management representation letter.

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- Failure to include a GAAP departure in the accountant's compilation or review report when management failed to segregate the current portion of long-term debt.
- Engagement letters with respect to engagements to compile financial statements that are not expected to be used by third parties and that omit the required descriptions or statements documenting the understanding with the client.
- Reference to the accountant's compilation report was not present on the financial statements.

.48 Although there are many recurring deficiencies noted in peer review, the accountant can take steps to avoid them by keeping these common mistakes in mind during the planning and performance of future compilation and review engagements. To view the latest full peer review report, please visit "Interest Areas—Peer Review" at www.aicpa.org.

Accounting Issues and Developments

.49 Given the current economic climate, certain accounting and financial reporting issues, such as the following, may be important to consider when compiling or reviewing financial statements:

- Fair value, including fair value measurements in illiquid markets
- Impairment

FASB Statement No. 168

.50 FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, as codified in FASB ASC 105, *Generally Accepted Accounting Principles*, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in their financial statements.

Referencing FASB ASC in Your Engagement Documentation

.51 It is only prudent to reflect current U.S. GAAP in your engagement documentation. The FASB notice to constituents includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*." Conversely, FASB suggests using the detailed numerical referencing system in engagement documentation, articles, textbooks, and related items.

.52 Also, because FASB ASC is not intended to change U.S. GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate. It is prudent to expect that engagement documentation associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

.53 However, if your firm's policies and procedures regarding engagement documentation will continue to follow grandfathered guidance not included in FASB ASC, it would be appropriate to continue to reference

those standards (and not FASB ASC). A listing of examples of grandfathered guidance can be found in FASB Statement No. 168.

.54 Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/FASBAccountingStandardsCodification.aspx.

Postcodification FASB References

.55 In spring 2010, the AICPA judgmentally selected 50 SEC filers and reviewed their 2009 Form 10-Ks to understand what type of references are actually being used in practice. All financial statements reviewed were for those entities having a fiscal year-end between December 1, 2009, and January 31, 2010, when the FASB codification was fully effective for all of these entities. The entities selected comprised the following:

- Fourteen large accelerated filers (28 percent of the sample)
- Twenty accelerated filers (40 percent of the sample)
- Seven nonaccelerated filers (14 percent of the sample)
- Nine smaller reporting companies (18 percent of the sample)

.56 Of all the entities selected, 50 percent had gone to mostly plain English references in their annual financial statements. However, among these entities, in the "Summary of Significant Accounting Policies" section of the financial statements, many entities did still use specific references to either old FASB standards (pre-FASB Statement No. 168 standards or legacy standards) or specific Accounting Standards Updates (ASUs), when appropriate. There did not seem to be much of a difference in this percentage among large accelerated filers, accelerated filers, and nonaccelerated filers. However, smaller reporting companies were less likely to use plain English (only 33 percent used plain English references).

.57 As for the remaining 50 percent of filers selected, they chose to use either FASB ASC-specific references (36 percent) or to do some sort of dual references (12 percent) between the precodification standards and new FASB ASC guidance. There was one entity that continued to use the old FASB references and did not mention FASB ASC in its financial statements.

.58 For those entities using FASB ASC references, most only referenced to the topic level and did not go down to the subtopic or section level. For those using dual references, in most cases, the new FASB ASC topic was listed first, with the historical FASB reference noted parenthetically. See the following table for a full breakout of the results:

	Plain English References	*FASB ASC References*	*Dual References*	*Old FASB References*
Large Accelerated Filers	7	4	2	1
Accelerated Filers	12	6	2	0
Nonaccelerated Filers	3	3	1	0
Smaller Reporting Companies	3	5	1	0
Total Sample	25	18	6	1

.59 The sampling results make it clear that although both FASB and the SEC have stated that the use of plain English is most appropriate when dealing with financial statements and notes to financial statements, not everyone is there yet. It will be interesting to see if the plain English references trend continues upward once entities have had another full year to get used to FASB ASC. In addition, all new guidance issued in 2010 was issued through ASUs, and there were no legacy standards issued. Therefore, we would expect that in 2010

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filings, even the "Summary of Significant Accounting Policies" section of financial statements would no longer refer to any legacy standards.

.60 We found that with the plain English references, some entities chose instead to say something like, "in accordance with the purchase method of accounting and as updated with FASB's April 2009 additional authoritative guidance for business combinations, we ...." Here the entity uses plain English but also makes it clear which new guidance they are following. This would be most important for those FASB changes with early adoption provisions to make it clear which method an entity used.

.61 FASB has stated that ASUs do not carry any authority. It is the updates that are made to the codification once the ASU is effective that are authoritative. Therefore, entities would be wise to ensure that when they are referring to authoritative literature, use of either plain English or the FASB ASC references would be appropriate, rather than just naming the ASU that brought about the change in accounting.

.62 In addition, entities would want to be sure that they do not refer to any legacy standards in their 2010 financial statements. Because all changes made to the codification in 2010 were through ASUs, referring to legacy standards is no longer correct. For example, since the codification became effective, there have been several updates to the *Fair Value Measurements and Disclosures* topic. Therefore, referring to FASB Statement No. 157, *Fair Value Measurements*, is no longer accurate because this standard does not incorporate changes made since the codification became effective in 2009. We would expect that entities that used dual references to both the legacy standards and FASB ASC references would not continue to use those dual references in 2010 financial statements.

.63 Many entities also have a section of their notes to financial statements titled "Effect of Accounting Pronouncements Not Yet Adopted." In 2010, we would expect the title of this section to change to something like "Effect of Authoritative Accounting Guidance Not Yet Adopted."

.64 It will be interesting to see if both public and nonpublic entities make any additional refinements or changes to their 2010 financial statements as we move into our first full year with FASB ASC. It is our understanding that the SEC may be issuing comment letters to those entities that are not properly reflecting the current state of U.S. GAAP in their financial statements, whether that be by using plain English or using the new FASB ASC references.

Decreases in Ownership of a Subsidiary

.65 In January 2010, FASB issued FASB ASU No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*. This ASU addresses implementation issues related to the changes in ownership provisions in FASB ASC 810-10 (issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*). These amendments clarify that the scope of the decrease in ownership provisions of FASB ASC 810-10 and related guidance applies to a subsidiary or group of assets that is a business or nonprofit activity, a subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture, and an exchange of a group of assets that constitutes a business or nonprofit activity for a noncontrolling interest in an entity (including an equity method investee or joint venture). Further, the amendments clarify that the decrease in ownership guidance in FASB ASC 810-10 does not apply to the following transactions, even if they involve businesses: sales of in-substance real estate and conveyances of oil and gas mineral rights. The amendment also expands the required disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of FASB ASC 810-10. This ASU is effective beginning in the period that an entity adopts FASB Statement No. 160. If an entity has already adopted this guidance, then the amendments in this ASU are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this ASU should be applied retrospectively to the first period that an entity adopted FASB Statement No. 160.

Accounting for Uncertainty in Income Taxes

.66 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities, and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.
- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FASB ASC 740-10-50-15[a]–[b]).

.67 For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009.

Consolidation of Variable Interest Entities

.68 For calendar year entities, 2010 is the first year of application of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB Statement No. 167 was incorporated into FASB ASC through ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities.* This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited.

.69 The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This statement also amends consolidation of variable interest entities (VIE) guidance to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

.70 Entities will be required to provide additional disclosures about involvement with VIEs and any significant changes in risk exposure due to that involvement. Entities also will be required to disclose how involvement with a VIE affects the entity's financial statements.

.71 FASB Statement No. 167 retains the scope of previous VIE consolidation accounting guidance, with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140,* which was incorporated into FASB ASC by ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*.

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.72 This statement also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a VIE or disclose information about its involvement in a variable interest entity, or both
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks associated with an enterprise's involvement with the VIE
- How an enterprise's involvement with the VIE affects the enterprise's financial position, financial performance, and cash flows

.73 This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited.

Accounting for Transfers of Financial Assets

.74 Calendar year entities must also start applying the provisions of FASB Statement No. 166 in 2010. FASB Statement No. 166, which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, requires more information about transfers of financial assets, including securitization transactions, and those circumstances in which entities have continuing exposure to the risks related to transferred financial assets. FASB Statement No. 166 was incorporated into FASB ASC by ASU No. 2009-16 and is discussed in FASB ASC 860, *Transfers and Servicing*. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. It is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

.75 Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance.

.76 The primary objectives of the disclosure requirements of this guidance are to provide the financial statement users with a clear understanding of the following:

- A transferor's continuing involvement (as defined by the FASB ASC glossary), if any, with transferred financial assets
- The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- How servicing assets and servicing liabilities are reported under this pronouncement
- For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows

.77 These objectives must be met by the disclosures, regardless of the specific requirements of the pronouncement. It may be the case that an entity provides greater detail than what is a required disclosure to meet these objectives, depending on the facts and circumstances.

Subsequent Events

.78 FASB Statement No. 165, *Subsequent Events*, which has been codified in FASB ASC 855, *Subsequent Events*, is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued). The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

.79 In particular, this statement sets forth the following:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

.80 FASB states that this guidance should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. In September 2009, the AICPA issued Technical Questions and Answers (TIS) section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), which notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. This question and answer can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

.81 For additional discussion regarding the accountant's responsibilities for subsequent events in compilation or review engagements, refer to the "TIS section 9150.26, 'The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements'" section of this alert.

Fair Value

.82 FASB ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity. *Fair value* is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Measuring Liabilities at Fair Value

.83 FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value* to increase the consistency in the application of FASB ASC 820 to liabilities because many constituents had expressed concern. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10.

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.84 This ASU states that, in circumstances in which a quoted price in an active market for the identical liability is not available, fair value of the liability must be measured by either (*a*) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities, or similar liabilities when traded as assets, or (*b*) another valuation technique that is consistent with the principles of FASB ASC 820, such as an income approach or a market approach. Further, if a restriction on the transference of the liability exists, the ASU clarifies that an entity is not required to factor that in to the inputs of the fair value determination. Lastly, the ASU also clarifies that a quoted price in an active market for the identical liability, or an unadjusted quoted price in an active market for the identical liability, when traded as an asset, are level 1 measurements within the fair value hierarchy. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after its issuance in August 2009. The full text of the ASU can be accessed from FASB's website at www.fasb.org.

Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

.85 FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both

- does not have a *readily determinable fair value*. The FASB ASC glossary states that an equity security has a readily determinable fair value if it meets any of the following conditions:
  - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year.
  - The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.
  - The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.
- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes are not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies.*

.86 As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the net asset value (NAV) per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

.87 This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

.88 These amendments are effective for interim and annual periods ending after December 15, 2009, and are included in FASB ASC 820-10. The AICPA practice aid *Alternative Investments—Audit Considerations* also

is available. The practice aid focuses on the existence and valuation assertions associated with alternative investments. Although that practice aid was written as a tool for auditors, accountants performing compilation or review engagements may find some useful information contained therein.

.89 In December 2009, the AICPA issued sections .18–.27 of TIS section 2220, *Long-Term Investments* (AICPA, *Technical Practice Aids*), to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers compliment the guidance provided in ASU No. 2009-12.

.90 Topics covered in these questions and answers include the following:

- The circumstances when NAV may be used to estimate the fair value of investments as a practical expedient
- How to identify the unit of account for interests in alternative investments
- Considerations for determining whether the reported NAV has been calculated in a manner consistent with FASB ASC 946
- Examples of circumstances when an adjustment to the reported NAV may be necessary
- How to adjust the reported NAV when it is not as of the reporting entity's measurement date
- How to adjust the reported NAV when it has not been calculated in accordance with FASB ASC 946
- The determination of the appropriate level within the fair value hierarchy for NAV of alternative investments in relation to the ability to redeem the investment versus the actual redemption request for the investment
- The definition of *near term* for the purposes of determining the appropriate level within the fair value hierarchy
- The tailoring of disclosures categories to address the nature and risks of investments
- Some considerations for determining the fair value of alternative investments when not utilizing NAV as a practical expedient

.91 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurements Disclosures

.92 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers between the three levels and the underlying reasons for such transfers would be useful to financial statements users.

.93 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

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.94 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.95 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Disclosures About Credit Quality and Allowance for Credit Losses

.96 In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. The ASU amends the existing disclosures to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis:

- A rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method. For each disaggregated ending balance, the related recorded investment in financing receivables should also be disclosed.
- The nonaccrual status of financing receivables by class of financing receivables.
- Impaired financing receivables by class of financing receivables.

.97 The amendments in this ASU require an entity to provide the following additional disclosures about its financing receivables:

- Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables (see FASB ASC 310-10-55-19 for examples of credit quality indicators)
- The aging of past due financing receivables at the end of the reporting period by class of financing receivables
- The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment

.98 An entity must also describe, by portfolio segment, its accounting policies and methodology used to estimate its allowance for credit losses, including the identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

.99 The amendments in this ASU apply to all entities with financing receivables. Examples of financing receivables include loans; trade receivables; notes receivable; and receivables relating to a lessor's leveraged, direct financing, and sales-type leases. See the "Pending Content" in paragraphs 13–15 of FASB ASC 310-10-55 for more information on the definition of *financing receivable*, including a list of items that are excluded from

the definition (for example, debt securities). In addition, the "Pending Content" in paragraphs 7–12 of FASB ASC 310-10-55 illustrates certain disclosures required by this ASU.

.100 For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

Convergence With International Financial Reporting Standards

.101 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and International Financial Reporting Standards (IFRSs) and eliminate the differences between them. In the Norwalk agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

SEC Work Plan for Consideration of IFRSs

.102 In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to the SEC's roadmap on its consideration of global accounting standards, including a confirmation of its continued support for the convergence of U.S. GAAP and IFRSs in order to narrow the differences between the two sets of standards. The SEC believes that a more comprehensive work plan is necessary to transparently lay out the work that must be done to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, time frame, and methodology for any such transition. Therefore, the SEC has indicated that it will carefully consider and deliberate whether these changes are in the best interest of U.S. investors and markets.

.103 The SEC directed its staff to execute a work plan, the results of which will aid the SEC in its evaluation of the impact that the use of IFRSs by U.S. entities would have on the U.S. securities market. The work plan includes consideration of IFRSs, both as they currently exist and after the completion of the various convergence projects underway by FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received on the roadmap, including the following:

- Sufficient development and application of IFRSs for the U.S. reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRSs
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

.104 Beginning no later than October 2010, and frequently thereafter, the SEC staff will provide public progress reports on the work plan, as well as the status of the FASB and IASB convergence projects, until the work is complete. By 2011, assuming completion of these convergence projects and the staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and

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how. Commentors provided feedback on the timing discussed in the roadmap, suggesting that a four or five year time frame would be necessary to successfully implement a change in their financial reporting systems to incorporate IFRSs. Under that assumption, if the SEC determines in 2011 to incorporate IFRSs into the U.S. financial reporting system, the first time that U.S. entities would report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of Release No. 33-9109 and also can be found on the SEC's website at www.sec.gov.

.105 In August 2010, the SEC issued two releases (Release Nos. 33-9133 and 33-9134, *Notice of Solicitation of Public Comment on Consideration of Incorporating IFRS Into the Financial Reporting System for U.S. Issuers*) to solicit public comment on its ongoing consideration of incorporating IFRSs into the financial reporting system for U.S. issuers. The first release contains requests for comment on three topics derived from the work plan that are related to the potential impact on investors. The second release contains requests for comment on three topics, also derived from the work plan, that are related to the potential impact on U.S. issuers. All comments will be available on the SEC's website at www.sec.gov.

International Financial Reporting Standard for Small and Medium-sized Entities

.106 The IASB issued *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs*) to be a self-contained global accounting and financial reporting standard applicable to the general purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs. *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability.

.107 The AICPA Governing Council recognizes the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs*, and a private company's expenditure of money, time and effort to convert to *IFRS for SMEs*. Information about IFRSs and *IFRS for SMEs* can be found at www.ifrs.com.

.108 Additionally, to help its membership, the AICPA has developed an IFRS for SMEs—U.S. GAAP Comparison Wiki. The purpose of the wiki is to provide a detailed and comprehensive comparison of *IFRS for SMEs* with corresponding requirements of U.S. GAAP. But it is more than just a comparison resource—it is a wiki. That means it is a collaborative, ongoing work in progress for anyone to contribute to and use. The wiki is found at http://wiki.ifrs.com/.

.109 At approximately 230 pages, *IFRS for SMEs* is a simplified version of full IFRSs. This guidance is the result of the overall cost-benefit analysis by the IASB in considering the needs of nonpublicly accountable entities and their financial reporting users, with the goal of providing a practical alternative to full IFRSs. With this view, the IASB eased certain recognition and measurement requirements by generally allowing only one accounting treatment. The accounting treatment in the standards is generally simpler than that allowed or required by full IFRSs. Also, disclosure requirements are reduced from full IFRSs, and topics not relevant to SMEs have been omitted from the standards. The IASB has further simplified the standards' usability by limiting revisions to *IFRS for SMEs* to once every three years. These simplifications provide a version of IFRSs that is less costly to implement than full IFRSs and perhaps more relevant to the users of SME financial statements.

.110 Some U.S. private companies may find the simplified *IFRS for SMEs* an attractive alternative to the more complicated and voluminous U.S. GAAP. Those private companies may find *IFRS for SMEs* to be a more relevant and less costly financial accounting and reporting standard than U.S. GAAP. Being based on full

IFRSs and missing many accounting topics, *IFRS for SMEs*, therefore, differs from U.S. GAAP in a variety of areas. Some of the key differences under *IFRS for SMEs* are the following:

- Disclosures are simplified in a number of areas, including pensions, leases, and financial instruments.
- Last in, first out (LIFO) is prohibited.
- Goodwill and indefinite life intangible assets are amortized over a period not exceeding 10 years.
- Depreciation is based on a components approach.
- The temporary difference approach to income tax accounting is simplified.
- Reversal of impairment charges, if certain criteria are met, is allowed.
- Accounting for financial assets and liabilities makes greater use of cost.

.111 Some key challenges that may be present in choosing to use *IFRS for SMEs* include understanding the differences between *IFRS for SMEs* and U.S. GAAP, the willingness of financial statement users to accept financial statements prepared under *IFRS for SMEs*, working with and accepting a more principles-based set of accounting standards compared with the more rules-based U.S. GAAP, the impact on taxes and tax planning strategies, and the impact on financial reporting metrics.

.112 Entities interested in *IFRS for SMEs*, or possibly adopting the standard, may find it helpful to take the following actions:

- *Monitor the efforts of the AICPA/FAF/NASBA "Blue Ribbon" Panel on Standard Setting for Private Companies*. For more information about the panel, go to www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176156684820.
- *Monitor convergence efforts of FASB and the IASB*.
- *Stay informed on SEC developments*. Public companies will be directly affected by the SEC's decision to adopt IASB standards. The future of private company reporting will also likely be impacted by an SEC mandate to adopt IFRS.
- *Develop a high-level analysis of the potential impact on accounting policies, processes and systems, contracts, legal agreements, and financing and tax structures*.

Private Company Financial Reporting

.113 The AICPA and the Financial Accounting Foundation established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel also is sponsored by the National Association of State Boards of Accountancy. The "blue-ribbon panel" will provide recommendations through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies are needed. The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities taking more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries. The panel's issued report will be made available to the public, and the resulting action plan is expected to be exposed for public comment prior to that plan being finalized. Although no deadline has been set for the panel's work, the recommendations are likely to come in 2010.

.114 During the July 2010 meeting of the panel, seven alternative models for private company financial reporting were discussed. Models based on IFRSs and a model that would have resulted in no change to private company financial reporting were eliminated. All remaining models would result in differences in GAAP for private and public entities; the main focus of the panel moving forward will be to select a model that is relevant to users of private company financial reports because this has become the overriding issue. The three primary models the panel agreed to focus on going forward are U.S. GAAP with Exclusions for

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Private Companies—with enhancements; U.S. GAAP—Baseline GAAP with Public Company Add-Ons; and Separate, Stand-Alone GAAP Based on Current U.S. GAAP. Most of the panel members also expressed their discontent with the current make-up of FASB and its heavy, but appropriate, focus on public companies. This led to another key discussion topic: the structure of whatever model is chosen—the current FASB; a restructured FASB (with greater private company representation); or a new, separate Private Company Standards Board under the oversight of the Financial Accounting Foundation.

Recent Accounting Pronouncements and Related Guidance for Nonpublic Companies

Recent ASUs

.115 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board *Accounting Standards Codification*	
Accounting Standards Update (ASU) No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
Liabilities Area of FASB ASC	
ASU No. 2009-15 (October 2009)	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
Broad Transactions Area of FASB ASC	

(continued)

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board ***Accounting Standards Codification***	
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2009-17 (December 2009)	*Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*
ASU No. 2009-16 (December 2009)	*Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-03 (January 2010)	*Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-24 (August 2010)	*Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-23 (August 2010)	*Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-07 (January 2010)	*Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*
ASU No. 2009-14 (October 2009)	*Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*

Recently Issued Technical Questions and Answers

.116 The following table presents a list of nonauthoritative accounting and audit and attest technical questions and answers recently issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

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Recently Issued Technical Questions and Answers
(AICPA, *Technical Practice Aids*)

Accounting

Technical Questions and Answers (TIS) section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments"
TIS section 6910.33 (December 2009)	"Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination"

(continued)

Recently Issued Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
TIS section 2220.27 (December 2009)	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
TIS section 2220.26 (December 2009)	"Categorization of Investments for Disclosure Purposes"
TIS section 2220.25 (December 2009)	"Impact of 'Near Term' on Classification Within Fair Value Hierarchy"
TIS section 2220.24 (December 2009)	"Disclosures—Ability to Redeem Versus Actual Redemption Request"
TIS section 2220.23 (December 2009)	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
TIS section 2220.22 (December 2009)	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"
TIS section 2220.21 (December 2009)	"Determining Whether an Adjustment to NAV Is Necessary"
TIS section 2220.20 (December 2009)	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, *Financial Services—Investment Companies*"
TIS section 2220.19 (December 2009)	"Unit of Account"
TIS section 2220.18 (December 2009)	"Applicability of Practical Expedient"
TIS section 6910.32 (July 2009)	"Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt"
TIS section 6910.31 (July 2009)	"The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the '5 Percent Test' Described in TIS Section 6910.30"
TIS section 6910.30 (July 2009)	"Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets"
TIS section 1600.04 (June 2009)	"Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements"
TIS section 1500.07 (June 2009)	"Disclosure Concerning Subsequent Events in OCBOA Financial Statements"
Audit and Attest	
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"

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Recently Issued Technical Questions and Answers **(AICPA, *Technical Practice Aids*)**	
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"
TIS section 8700.02 (September 2009)	"Auditor Responsibilities for Subsequent Events"
TIS section 8700.01 (September 2009)	"Effect of FASB ASC 855 on Accounting Guidance in AU Section 560"

.117 The AICPA also recently issued two new questions and answers that specifically apply to compilation and review engagements, as follows.

TIS section 9150.26, "The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements"

.118 This question and answer was issued in response to FASB's 2009 addition of subsequent events into accounting literature, which is now codified in FASB ASC 855. This question and answer discusses how the entity's responsibility to disclose the date through which subsequent events have been evaluated (per FASB ASC 855-10-50-1) affects the accountant's responsibilities for subsequent events in a compilation and review engagement. This question and answer points out that FASB ASC 855 does not change the accountant's responsibilities under SSARSs. TIS section 9150.26 is reprinted in its entirety in appendix D, "'The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements.'"

TIS section 9150.27, "The Accountant's Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report"

.119 This question and answers clarifies that the term *where applicable*, as discussed in paragraph .79(a) of AR section 100, refers to a situation in which the accountant has not reported on compiled financial statements not intended for third party use. In the case of a review or compilation in which the accountant has issued a report, then a revised accountant's report should be issued and the reason for the financial statement's revision usually should be described in the revised report, as well as in a note to the revised financial statements. TIS section 9150.27 is reprinted in its entirety in appendix E, "'The Accountant's Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report.'"

Recent AICPA Independence and Ethics Developments

.120 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.121 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3. Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as maintaining internal control for the client. For example, bookkeeping is recognized to be part of the Committee of Sponsoring Organizations of the Treadway Commission's information and communication element of internal control. Additionally, some nonattest activities, such as performing calculations (for example, tax provision, leases, LIFO reserve); maintaining ledgers (for example, fixed asset ledger); performing reconciliations; and identifying adjusting journal entries, have been viewed as maintaining the client's controls, regardless of whether management has met the general requirements of Interpretation No. 101-3 (that is, oversees the service, reviews and approves the work. and makes all significant judgments and decisions).

.122 To address the possible inconsistency in Interpretation No. 101-3, PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members better distinguish between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

.123 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings, can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

.124 Exposure drafts issued by PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

New AICPA Products and Publications

.125 The AICPA has recently developed a brand new guide, *Compilation and Review Engagements*. This guide provides additional information on implementing SSARS No. 19. It includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. See www.cpa2biz.com and enter product no. 0128110 for further information. You can also save more than $10 when you purchase both the guide and SSARS No. 19 as a set online using product no. 0129010HI.

On the Horizon

.126 Accountants should keep abreast of compilation, review, and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to your clients or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.127 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting, compilation, and review projects exist, in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

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SSARS Pipeline

SSARS Clarity Project

.128 In response to growing concerns about the complexity of standards, the ASB commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the International Standards on Auditing (ISAs) issued by the IAASB. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the first half of 2011.

.129 In its May 2010 meeting, ARSC agreed to begin working to clarify the current SSARSs literature using the same conventions as the ASB project. The ARSC project is expected to begin in late 2010 and continue through 2011.

Codification of Existing SSARSs

.130 The issuance of SSARS No. 19 resulted in the separation of the compilation and review engagement framework, compilation standards, and review standards into three new codified sections. These new sections became AR section 60, *Framework for Performing and Reporting on Compilation and Review Engagements*; AR section 80, *Compilation of Financial Statements*; and AR section 90, *Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2). Once SSARS No. 19 is fully effective, AR section 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services*; AR section 50, *Standards for Accounting and Review Services*; and AR section 100 will be removed from *Professional Standards*.

.131 In addition, those AR sections that were not superseded by SSARS No. 19 will be conformed so that the performance and reporting requirements are consistent with SSARS No. 19. It is expected that the 2011 SSARSs codification will be fully conformed to SSARS No. 19.

Consideration of International Compilation and Review Standards

.132 The IAASB is currently working on redrafting International Standard on Related Services 4410, *Engagements to Compile Financial Statements*, and International Standard on Review Engagements 2400, *Engagements to Review Financial Statements*.

.133 The IAASB plans to further deliberate this project at its September 2010 public meeting. ARSC plans to comment on the IAASB proposed standards when such standards are exposed for public comment. Such standards are expected to be exposed by the end of 2010. ARSC will continue to monitor the progress of the IAASB project and consider how any changes to the international compilation and review standards might be converged with the current SSARSs. Further information on the IAASB project is available through the project summary on the IAASB website at www.ifac.org/IAASB.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.134 FASB expects 2010 to be a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards,

subject to the required due process. Most recently, FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Other MoU projects
- Other joint projects

.135 A progress report for the quarter ended March 31, 2010, highlighted the following topics: (*a*) on the financial instruments and insurance contracts topics, the boards have reached different conclusions on significant technical issues that may affect the project timetables of these topics, and (*b*) the boards agreed to explore an alternative approach to lessor accounting that may affect the project timetable of this topic. FASB and the IASB also have several other joint projects in process, including balance sheet—offsetting, emissions trading schemes, and reporting discontinued operations. In March 2010, the exposure draft *Conceptual Framework for Financial Reporting* was published for public comment. In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. Specifically, the boards were scheduled to expose for comment numerous major exposure drafts during the second quarter of 2010, and stakeholders voiced concern about their ability under those circumstances to provide high-quality input. The boards have developed a modified strategy to accommodate these concerns by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate consultation document seeking stakeholder input about effective dates and transition methods.

.136 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. The boards also decided to issue separate exposure drafts to address differences in the two sets of standards on balance sheet netting of derivative contracts and other financial instruments. The IASB has also made its projects on improved disclosures about derecognized assets and other off balance-sheet risks, consolidations, and insurance contracts priorities. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, has been extended into the second half of 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively impact the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the US financial system.

.137 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Comprehensive Income Exposure Draft

.138 In May 2010, FASB issued a proposed ASU on comprehensive income that would require an entity to report total comprehensive income in a continuous financial statement in two parts: net income and other

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comprehensive income. In that financial statement, the components of net income and the components of other comprehensive income should be displayed. The proposed ASU is intended to simplify how comprehensive income is reported by eliminating two options for how items of comprehensive income are displayed. The proposed ASU contains illustrative examples of the revised financial statement. This proposed ASU is the result of a joint project as part of IFRSs and U.S. GAAP convergence, and the IASB has separately issued a similar document. The proposed amendments would be applied on a fully retrospective basis to improve comparability between reporting periods. Further, because compliance with the proposed amendments is already permitted, early adoption would be permitted. FASB plans to align the effective date with the effective date of the amendments in the proposed ASU on financial instruments. The IASB and FASB aim to finalize an improved and converged standard on other comprehensive income in the fourth quarter of 2010.

Financial Instruments Exposure Draft

.139 Also, in May 2010, FASB issued a proposed ASU on accounting for financial instruments, derivative instruments, and hedging activities. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments, removes the threshold for recognizing credit impairments creating a single credit impairment model for both loans and debt securities, and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.
- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, a reconciliation from amortized cost to fair value would be required on the statement of position; with the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period. Therefore, net income will remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period.
- The existing probable threshold for recognizing impairments on loans would be removed. (Currently, FASB ASC 310-10-35-4 states that the concept in U.S. GAAP is that impairment of receivables [including loans] should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. Probable is defined by FASB ASC 310-10-20 as when the future event or events are likely to occur).
- For changes in value of financial instruments measured through other comprehensive income, an entity is required to determine if a credit impairment is appropriate at the end of each reporting period based on information related to past events and existing economic conditions. An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts the entity does not expect to collect.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected, which would better reflect a financial instrument's interest yield.
- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as

the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.

- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.140 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short-term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments). This proposed ASU was not issued jointly with the IASB and does not contain converged guidance; however, the goal still remains for both boards to issue comprehensive improvements to foster international comparability of financial information about financial instruments. The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009. The IASB also issued two exposure drafts on amortized cost and impairment and fair value option for financial liabilities in late 2009 and mid-2010, respectively; the third topic, hedge accounting, is still being deliberated by the IASB, and an exposure draft is expected in the near term. The boards have stated that they will consider together the comment letters and other feedback received on each boards' exposure drafts in an effort to reconcile their differences in ways that foster improvement and convergence. The effective date of these amendments will be established upon issuance of the final ASU which is expected in the second quarter of 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional 4 years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

Revenue Recognition Exposure Draft

.141 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from Contracts with Customers*, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.142 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities (for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (*performance obligation* is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).

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- determine the transaction price (*transaction price* is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.143 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*) recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

.144 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the boards plan to invite additional comment through a separate consultation on how best to transition over to the new standards. Therefore, no expected specific effective date is stated at this point. Comments on the exposure draft are due on October 22, 2010. This topic is considered by many to be the most pervasive of any FASB has ever worked on. The reader is encouraged to review the exposure draft, consider if it is operational to you or your clients' common revenue transactions, and share any resulting concerns with FASB. The boards also anticipate holding public roundtable meetings after the end of the comment period.

Fair Value Exposure Draft

.145 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.146 The first two of these significant amendments are intended to clarify the application of existing fair value measurement guidance. The last three of these significant amendments would change a particular principle of fair value guidance.

.147 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines *highest and best use* as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or

the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values do not depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.148 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

.149 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to interest rate risk, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice. However, they might affect the current practice for reporting entities that apply the in-use valuation premise more broadly.

.150 The proposed amendments regarding the application of blockage factors and other premiums and discounts in fair value measurements would make two changes to current guidance. Currently, under U.S. GAAP, use of a blockage factor in fair value measurements is only prohibited when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). This would be level 1 within the fair value hierarchy. The first change from the proposed amendments is that a blockage factor is not relevant and, therefore, also should not be used when fair value is measured using a valuation technique that does not use a quoted price. This would be level 2 or level 3 within the fair value hierarchy. Second, the amendments specify that fair value measurements categorized within level 2 and level 3 take into account other premiums and discounts when market participants would consider those premiums or discounts when pricing an asset or a liability, consistent with the unit of account for that asset or liability. Examples include a control premium or a noncontrolling interest discount. These proposed amendments may affect current practice for any reporting entities applying a blockage factor in fair value measurements that is measured using quoted prices and categorized within level 2 of the fair value hierarchy.

.151 Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

- The effect on a fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances
- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use
- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

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.152 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs.

Financial Statement Presentation Staff Draft

.153 FASB and the IASB are working together to establish a common standard that would improve how information is organized and presented in financial statements. This common standard is intended to address users' concerns that existing requirements permit too many alternative types of presentation and that information in financial statements is highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between an entity's financial statements and its financial results. In 2008, a discussion paper was issued by the boards that outlined the proposed principles for presenting financial statements in a way that portrays a cohesive financial picture of an entity.

.154 Given the magnitude of this project, the expected implementation costs, and the substantial effects it will have on financial statement presentation for many years to come, the boards decided in May 2010 to modify the strategy for this project. Before finalizing an exposure draft, the boards decided to engage in additional outreach activities that focus on the perceived benefits and costs of the proposals and the implications of the proposals for financial reporting by financial service entities. The boards plan on discussing these two areas of focus with preparers and users of financial statements. This outreach will be based on a rough draft of a proposed standard, known as a *staff draft*, and reflects the cumulative tentative decisions made by the boards, concluding with their joint meeting in April 2010. This staff draft was made publicly available solely for this purpose.

.155 The proposals in this project would be applicable to all entities, except a benefit plan within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*; FASB ASC 962, *Plan Accounting—Defined Contribution Pension Plans*; and FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans* or IAS 26, *Accounting and Reporting by Retirement Benefit Plans*. The two core financial statement principles in this proposal are cohesiveness and disaggregation. A common structure for the statements of financial position, comprehensive income, and cash flows would be established in the form of required sections, categories or subcategory, and related subtotals. Some proposed specific changes in the classification and format of financial statements include the following:

- Related information would be displayed in the same sections, categories, and subcategory in each statement so that information is more easily associated.
- Presentation of business and financing activities would be separated as follows:
    - The business section would include items that are part of an entity's daily operations and other income generating activities.
    - The financing section would include items that are part of an entity's activities to obtain (or repay) capital.
- Discontinued operations and income taxes would be presented in their own separate sections.
- The statement of changes in equity would not include the sections and categories used in the other statements because that statement presents information solely about changes in items classified in the equity category in the statement of financial position.

.156 Further, FASB plans to propose some changes that are already required by IAS 1, *Presentation of Financial Statements*. The proposal would define, and provide the requirements for, a complete set of financial statements. Currently, a complete set of financial statements for the period is defined only in the FASB Concepts Statements. An entity would also be required to present one period of comparative information. A

complete set of financial statements would consist of, at a minimum, statements of financial position, comprehensive income, cash flows and changes in equity, and notes to financial statements for two periods (the current period and the previous period). Also, an opening statement of financial position would be part of a complete set of financial statements if an entity applies an accounting principle retrospectively, restates its financial statements, or reclassifies items in the financial statements.

.157 The boards' tentative decisions on financial statement presentations do differ in a few ways in relation to minimum line requirements for the statement of financial position, segment reporting, and net debt presentation. Of these three, the differing stance on segment reporting is the only significant difference. The boards now aim to issue an exposure draft in the first quarter of 2011 and a final improved and converged standard in the fourth quarter of 2011. Both the introduction to the staff draft and the staff draft can be accessed from FASB's website at www.fasb.org.

Leases Exposure Draft

.158 During the third quarter of 2010, the IASB and FASB published for public comment joint proposals to improve the financial reporting of lease contracts. These proposals would result in a consistent approach to lease accounting for both lessees and lessors—a right-of-use approach. This would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, therefore providing more complete and useful information to investors and other users of financial statements. Currently, the accounting for a lease depends on its classification; an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRSs or U.S. GAAP, whereas a capital lease results in the lessee recognizing an asset and obligation. Under the proposed guidance, lessees would only have one method of accounting for leases, which would produce more complete and comparable financial reporting, in addition to reducing the opportunity to structure transactions to achieve a desired accounting outcome.

.159 The scope of the new lease guidance includes all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. Under this new guidance, all lessees would use a single method of accounting for all leases: an asset would be recognized representing the lessee's right to use the leased (underlying) asset for the lease term (the right-of-use asset), and a liability at the present value of the expected lease payments would also be recognized.

.160 A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either (*a*) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or (*b*) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach). The assets and liabilities recognized by both lessors and lessees would be measured on the basis that

- assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- a remeasurement is triggered when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

.161 For leases of 12 months or less, lessors and lessees would be able to apply simplified requirements. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. New disclosures would also be required.

.162 In early 2009, the boards issued a discussion paper on leases; this exposure draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors,

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regulators, and other interested parties since that discussion paper. The comment period is open until December 15, 2010. During the comment period, the boards will undertake further outreach activities, including public round-table meetings to ensure that the views of all interested parties are taken into consideration before the new standard is completed. Also, the boards will share and jointly consider all comment letters received. A final standard is expected in 2011.

FASB Accounting Pipeline

Disclosure of Certain Loss Contingencies

.163 In July 2010, FASB issued an exposure draft on the disclosure of certain loss contingencies in response to concerns from investors and other financial statement users that the current disclosures do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. The objective of these disclosures would be for an entity to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following: the nature of the loss contingencies, their potential magnitude, and their potential timing (if known). Disclosure of certain remote loss contingencies would be required and, therefore, would expand the population of loss contingencies that are required to be disclosed. An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required. Further, current qualitative disclosures would be enhanced by requiring additional disclosures. These additional required qualitative and quantitative disclosures include the following:

- For litigation contingencies, the contentions of the parties and how users can obtain more information about the litigation
- Publicly available quantitative information, such as the claim amount for asserted litigation contingencies; other relevant nonprivileged information; and, in some cases, information about possible recoveries from insurance and other sources
- For public entities, tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the period

.164 The amendments in this proposal would affect all entities. The exposure draft noted that FASB will continue to work with the Public Company Accounting Oversight Board, the AICPA, and the American Bar Association (ABA) to identify and address any potential implications of the proposed amendments for auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The proposed amendments would be effective for fiscal years ending after December 15, 2010, for public entities and in the first annual period beginning after December 15, 2010, for nonpublic entities. The comment period ended in September 2010.

Going Concern FASB Project

.165 Currently, the accounting guidance with respect to going concern resides in the auditing literature, as well as in SSARSs. This project's intention is to appropriately incorporate going concern guidance into U.S. GAAP. Specifically, this guidance would discuss the following:

- Preparation of financial statements as a going concern
- An entity's responsibility to evaluate its ability to continue as a going concern
- Disclosure requirements when financial statements are not prepared on a going concern basis
- Disclosure requirements when there is a substantial doubt about an entity's ability to continue as a going concern
- The adoption and application of the liquidation basis of accounting

.166 A revised exposure draft is expected to be issued in the fourth quarter of 2010, with a final ASU expected in the first quarter of 2011. FASB has decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Readers should be alert to developments on this topic.

Other Accounting Projects

.167 Additionally, FASB has the following projects underway:

- Troubled debt restructuring
- Disclosure framework
- Investment properties

Resource Central

.168 The following are various resources that practitioners performing compilation and review engagements may find beneficial.

PCPS SSARS No. 19 Toolkit

.169 The PCPS has developed a SSARS No. 19 toolkit to support practitioners with implementing SSARS No. 19 and communicating SSARS No. 19 within the accounting firm and to clients. The SSARS No. 19 toolkit includes the following components:

- *Comparative overview of compilation, review, and audit brochure (available to all AICPA members)*. The level of service provided in an engagement is generally determined by the needs of the client and the requirements of the client's creditors or investors. This customizable brochure is provided to assist practitioners with educating clients in the differences between compilation, review, and audit engagements and has been updated for SSARS No. 19 guidance.
- *SSARS No. 19 frequently asked questions (FAQs) (available only to PCPS member firms)*. The FAQs are intended to address the most common practitioner questions related to applying SSARS No. 19 and include a side-by-side compilation and review comparison grid, as well as illustrative comparison grids of previous and new reporting elements. In addition, they provide links to additional resources needed to further understand and apply SSARS No. 19.
- *SSARS No. 19 overview PowerPoint presentation (available only to PCPS member firms)*. This PowerPoint presentation is designed for practitioners to educate their staff and clients about SSARS No. 19.
- *SSARS No. 19 educate your client communications (available only to PCPS member firms)*. This template can be used by practitioners in newsletters or website communications to educate clients about the differences between the requirements of compilations, reviews, and audits and to communicate the impact of SSARS No. 19 on the client's engagement.
- *SSARS No. 19 management representation checklist for review engagements (available only to PCPS member firms)*. As part of a practitioner's client's review engagements, client management is required to provide the practitioner a written letter that includes documentation about representations made during the review. This checklist is designed to assist the practitioner in requesting representations required for all financial statements and periods covered by the accountant's review report ending on or after December 15, 2010.

.170 For additional information on the SSARS No. 19 toolkit, refer to www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/Resources/KeepingUp/Pages/SSARSNo19Toolkit–PCPSMembers.aspx.

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Publications

.171 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- SSARS No. 19, *Compilation and Review Engagements* (product no. 060657 [paperback] or 060657PDF [online])
- Guide *Compilation and Review Engagements* (2010) (product no. 0128110 [paperback] or WRC-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- *Accounting Trends & Techniques, 63rd Edition* (product no. 0099009 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099109 [paperback] or WIF-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Financial Reporting Alert *Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

AICPA Online Professional Library: Accounting and Auditing Literature

.172 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with* FASB Accounting Standards Codification™, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]). To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.173 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop (2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Strong Foundation* (product no. 741602 [text], 181601 [DVD/Manual], or 351601 [Additional Manual for DVD]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

.174 Among the many courses, the following are specifically related to compilation and review engagements:

- *Small Business Audit, Compilation and Review Update* (product no. 734522 [text])
- *Accounting Services, Compilations and Reviews: Effective Risk Management* (product no. 732825 [text])
- *Advanced Update for Compilation, Review and Accounting Services* (product no. 731556 [text])
- *Managing Compilation, Review and Accounting Services* (product no. 733482 [text])
- *Performing Compilation and Review Engagements* (product no. 739700 [CD-ROM])
- *Advanced Issues in Compilation, Review and Accounting Services* (product no. 733383 [text])
- *Compilation and Review Engagement Essentials* (product no. 733881 [text])
- *Compilation, Review and Accounting Service Update* (product no. 733373 [text])
- *Compiling Personal Financial Statements* (product no. 733503 [text])
- *InSight: SSARS 19—The New Compilation and Review Standard* (product no. 154230 [online])

.175 Visit www.cpa2biz.com for a complete list of CPE courses.

.176 In fall 2010, the AICPA will release on-demand CPE courses, including case studies, that address how to perform a review under SSARS No. 19.

Online CPE

.177 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to those performing compilation and review engagements include the following:

- *2010 Annual A&A Update: Compilation and Review Update*
- *Comp and Review Engagements: Current Practices; Accounting & Reporting Issues; Potential Change*
- *Compilations and Reviews: "Introduction and Background" plus "Engagement Planning and Administration"*
- *Drafting Audit, Review, and Compilation Reports*
- *Comp and Review Engagements: Recent SSARS Developments and Current Practice Issues*
- *Intro to Cash and Tax OCBOAs and Their Effects on Procedures in Audits, Reviews, and Compilations*
- *Compilations and Reviews: Independence Considerations*

.178 To register or learn more, visit www.cpa2biz.com.

Webcasts

.179 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.180 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

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Hotlines

Accounting and Auditing Technical Hotline

.181 Do you have a complex technical question about review, compilation, accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 by e-mail at aahotline@aicpa.org, or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.182 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

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Appendix A—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org

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Website Name	*Content*	*Website*
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org

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Appendix B—Significant Change to Compilation Reporting Requirements When Independence Is Impaired

During its November 2009 meeting, the AICPA's Accounting and Review Services Committee (ARSC) removed, at the urging of many local and smaller firm CPAs and certain user groups, a prohibition against stating the reasons why an accountant was not independent when performing a compilation service.

Many accountants are finding that their independence with respect to a compilation client is impaired for a number of reasons. Examples of impairments include the performance of certain nonattest services, ownership in the client's business, or having certain relationships with the client. Prior to the issuance of Statement on Standards for Accounting and Review Services (SSARS) No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2), an accountant was prohibited from including in his or her compilation report the reasons for an impairment of independence. An accountant could only state that he or she was not independent. Consequently, users who wanted to understand the reasons for an independence impairment needed to contact the client or the accountant for more information. Because of this interest on the part of users and to improve the overall transparency in the compilation report, ARSC decided to remove the prohibition and allow an accountant, if he or she chooses, to state the reasons for an independence impairment in the compilation report.

Although most provisions of SSARS No. 19 will not be effective until on or after December 15, 2010, ARSC felt that it was important to permit accountants to disclose the reasons for an independence impairment in the compilation report as soon as practicable. Therefore, the standard has an exception that this specific provision (set forth in paragraph 2.21 [AR sec. 80 par. .21] of SSARS No. 19) may be implemented early. This appendix discusses, in a question and answer format, this specific paragraph and the alternatives that will now be available to accountants.

Question—To what compilation engagements does SSARS No. 19 apply?

Answer—SSARS No. 19 applies to compilations of financial statements and other specified elements, accounts, or items of a financial statement and pro forma financial information performed in accordance with SSARSs. SSARS No. 19 does not apply to engagements to compile prospective financial information. Such engagements would be performed in accordance with AT section 301, *Financial Forecasts and Projections* (AICPA, *Professional Standards*, vol. 1). Paragraph .23 of AT section 301 states that the reason for a lack of independence should not be described in the compilation report.[1]

Question—When may I start describing the reasons for lack of independence in my compilation report?

Answer—SSARS No. 19 was issued in December 2009. Therefore, you may begin using the provision in paragraph 2.21 (AR sec. 80 par. .21).

Question—May I disclose the reasons for the lack of independence only for December 2009 compilations and subsequent periods, or may I use it for earlier compilations (for example, November 2009 compilations)?

Answer—You may disclose the reasons for a lack of independence in a November (or earlier) compilation report as long as your report is released (or reissued) after December 30, 2009, which was the official issuance date of SSARS No. 19.

Question—May I start using the new standard compilation report illustrated in SSARS No. 19 now?

Answer—No. The effective date of SSARS No. 19 is for compilations and reviews of financial statements for periods ending on or after December 15, 2010. Early implementation of the new standard is not permitted, except for the one paragraph permitting disclosure of the reasons for a lack of independence in the compilation report. Therefore, you cannot use the new standard compilation report until SSARS No. 19 becomes effective.

[1] In June 2010, the Accounting and Review Services Committee released a proposed Statement on Standards for Attestation Engagements (SSAE), *Reporting on Compiled Prospective Financial Statements When the Practitioner's Independence Is Impaired*. This proposed SSAE would revise the attestation standards to permit the disclosure of the reasons for an independence impairment in such compilation reports. For the current status of this project, visit www.aicpa.org.

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Question—Does SSARS No. 19 require me to state the reasons why I'm not independent with respect to a compilation client?

Answer—No. SSARS No. 19 permits, but does not require, the accountant to disclose the reasons. You may simply state that you are not independent with respect to the client without disclosing the reasons.

Question—May I disclose the reasons for the lack of independence in one period and then not disclose the reasons in a subsequent period for the same client?

Answer—Yes. Each period for which a compilation report is issued for a client is treated as a separate compilation. For example, you may decide to disclose the reasons in a compilation report on financial statements for the period ended March 31, 2010, and then decide to not disclose the reasons in a compilation report on financial statements for the period ended June 30, 2010, or vice versa.

Question—Are there factors that I should consider before deciding to disclose the reason(s) for the impairment?

Answer—An accountant should exercise his or her professional judgment in making that decision. That judgment might include consideration of such factors as the number of reasons for independence impairment or the ability of the user of the compiled financial statements to understand the nature of the impairments.

Paragraph 2.21 (AR sec. 80 par. .21) of SSARS No. 19 states in part, "If the accountant elects to disclose a description about the reasons his or her independence is impaired, the accountant should ensure that all reasons are included in the description." Therefore, if the accountant's independence is impaired for three reasons (for example, ownership, nonattest services, and family relationships), the accountant may decide that describing all three would make the report too lengthy or too confusing. Consequently, the accountant might decide to stay with the extant language and merely say that he or she is not independent. On the other hand, an accountant who is providing a nonattest service that impairs independence may feel that this information would be beneficial for users to know. Therefore, that accountant may decide to disclose the reason.

Question—Are there any limitations on what the report may say?

Answer—No. ARSC did not prescribe any requirements except that if an election is made to describe, then all the reasons for the impairment must be described. That means that an accountant could, if he or she chooses, write a paragraph three pages long to describe the reasons for the impairment. Although that length certainly isn't expected, ARSC anticipates and expects that some accountants will go into far greater detail than will others.

Question—Assuming an accountant is not independent for two reasons (for example, a family relationship and ownership) does each reason need to be in a separate paragraph?

Answer—No. An accountant may combine the reasons into a single paragraph. For example, assuming the accountant held an ownership interest in the client and the accountant's spouse was the CFO of the company, a description paragraph may be drafted, such as the following:

> I am not independent with respect to XYZ Company as of and for the year ended December 31, 2010, because I am a minority shareholder in XYZ Company and my spouse is an officer of XYZ Company.

Question—Assuming an accountant's independence is impaired because the accountant maintains a number of controls for the client, does each area of internal control need to be listed by the accountant, or may the accountant merely say that his or her independence is impaired because he or she maintained internal controls?

Answer—The provision is flexible and allows an accountant to provide as much detail as he or she feels appropriate in the circumstances. Therefore, the accountant may either state the areas of internal control maintained by the accountant or provide a general description of the reason or give no reason at all and merely say that he or she is not independent. In making this decision, the accountant should make sure that his or her description is not misleading. For example, if the accountant is maintaining only small aspects of internal control over financial reporting, the accountant would not want to describe the reason by saying that he or she is maintaining all controls for the client. Such a statement would be misleading and inaccurate.

Question—May this provision be used for review reports as described in the exposure draft?

Answer—No. Although the exposure draft did include a situation whereby an accountant could design or operate aspects of internal control over financial reporting for a client and also perform a review, this provision was not included in the final standard. Paragraph 3.2 (AR sec. 90 par. .02) of SSARS No. 19 states that the accountant is precluded from performing a review engagement if the accountant's independence is impaired for any reason.

Question—Where should I go if I have additional questions?

Answer—Members having additional questions regarding any of the provisions of SSARS No. 19 should contact the AICPA's accounting and auditing hotline at 1-877-242-7212, through e-mail at aahotline@aicpa.org, or through the following website: www.aicpa.org/Research/TechnicalHotline/Pages/AccountingAuditingTechnicalHelpQA.aspx.

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Appendix C—"Changes on Tap for Compilation and Review Standards"

Significant changes to the standards for compilation and review engagements will soon take effect. The AICPA's Accounting and Review Services Committee (ARSC) issued Statement on Standards for Accounting and Review Services [SSARS] No. 19, *Compilation and Review Engagements* [(AICPA, *Professional Standards*, vol. 2)], in December [2009]. The standard's effective date is for compilations and reviews of financial statements for periods ending on or after Dec. 15, 2010, with early implementation permitted for the new reporting option for compilation engagements when the accountant's independence is impaired. This article discusses the major changes made by the standard.

Disclosure of Reasons for Lack of Independence

SSARS No. 19 contains the most significant changes to the professional literature for compilation and review engagements since SSARS No. 1, *Compilation and Review of Financial Statements* [(AICPA, *Professional Standards*, vol. 2, AR sec. 100)], was issued in December 1978. For more than 30 years, accountants have been required to disclose in the compilation report if they are not independent but have been prohibited from disclosing the reasons. It was thought that while it was important for users to know whether the accountant was independent, the reasons were not relevant and, in fact, could cause confusion among financial statement users.

However, with the increasing complexity of new accounting standards, many smaller companies are asking for their accountant's assistance in preparing high-quality, reliable financial statements. This assistance, which often includes preparing and posting payroll and payroll reports, maintaining the general ledger, and preparing and recording journal entries, may cause the accountant to impair his or her independence.

As a result, members advised ARSC that third-party users (primarily bankers) wanted to know and understand the reasons for the impairment. What ARSC found out is that many bankers view a technical impairment caused by the accountant's involvement in a client's system of internal control different from an impairment caused by a financial interest or a relationship with the client.

After studying the issue, ARSC developed the new standard so that the accountant has the option, but is not required, to disclose the reasons for an independence impairment in a compilation report. The only caveat is that, if the accountant does decide to disclose the reasons for an independence impairment, *all* reasons must be disclosed. The result will be reports that are more transparent and useful to users of compiled financial statements.

Separating Compilation Guidance From Review Guidance

Another significant change is the separation of the compilation guidance from the review guidance. SSARS No. 19 supersedes AR sections 20, *Defining Professional Requirements in Statements on Standards for Accounting and Review Services*; 50, *Standards for Accounting and Review Services*; and 100, *Compilation and Review of Financial Statements* [(AICPA, *Professional Standards*, vol. 2)]. In the place of those AR sections, the requirements and guidance will be separated into the following sections:

- Framework for Performing and Reporting on Compilation and Review Engagements
- Compilation of Financial Statements
- Review of Financial Statements

This change was in direct response to member comments that they had difficulty in researching the existing literature since the requirements and guidance for compilation and review engagements were presented together. For example, under the pre-SSARS No. 19 standards, an accountant looking to understand the compilation standards would have to sort through both compilation and review guidance because they were presented together. Now, the framework and compilation sections contain all the necessary requirements and guidance. In fact, an accountant who just performs compilations can rip the framework and compilation

sections out of the [*Codification of Statements on Standards for Accounting and Review Services*] and have all of the professional literature that he or she needs.

Clarification of Review Performance Procedures

Another important change was made in the review standards where ARSC felt more guidance around the planning of review procedures was needed. ARSC noted that, to properly plan the nature and extent of review procedures, an accountant cannot merely use a canned list of analytical and inquiry procedures. Rather, an accountant should tailor those procedures, taking into consideration those areas where the accountant believes there are increased risks of misstatements. In that respect, a review engagement is not simply a compilation engagement with a few additional procedures layered on top. A review is an assurance engagement and needs to be planned and performed to obtain a limited level of assurance that the financial statements are free of material misstatement.

A review engagement requires the accumulation of *review evidence* that will provide the accountant with a reasonable basis for obtaining *limited assurance* that there are no material modifications that should be made to the financial statements for the statements to be in accordance with the applicable financial reporting framework.[1] That compares to an auditor's objective, which is to accumulate greater evidence to obtain a reasonable or high level of assurance. Limited assurance can generally be obtained by performing analytical and inquiry procedures whereas an audit contemplates much greater testing through inspection, observation, confirmation, and the examination of source documents.

While SSARS No. 19 does not require the accountant to ordinarily perform procedures beyond analytical procedures and inquiries, it does require the accountant to use professional judgment in determining the specific procedures and tailor those procedures accordingly. A trend analysis may be an appropriate analytical procedure for client A; however, that same analysis may not be appropriate for client B. Additionally, the inquiries that are made to management should be tailored. The accountant should tailor his or her analytical procedures and inquiries to that specific client based on an understanding of the industry, knowledge of the client, and awareness of the risk that the accountant may unknowingly fail to modify his or her review report on financial statements that are materially misstated.

SSARS No. 19 also attempts to clear up the misconception that a review engagement is always limited to analytical procedures and inquiries. If the accountant performs a trend analysis and the results indicate that accounts receivable increased by an unexpected amount and the client's response to the accountant's inquiry does not satisfy the accountant, other procedures should be performed. Such other procedures may include making additional inquiries of client management or personnel, performing additional analyses, or confirming certain receivables. A mistaken assumption is that once an "audit-type" procedure is performed, the accountant is required to perform an audit. Although certain procedures are ordinarily performed in an audit and not in a review, the accountant should perform additional procedures he or she believes necessary to obtain limited assurance that the financial statements are free of material misstatement when the accountant becomes aware that there may be a material misstatement.

Documenting the Understanding With Management

SSARS No. 19 does not change the accountant's requirement to establish an understanding with the client's management regarding the services to be performed with respect to both compilation and review engagements. However, whereas previous standards stated that it is preferable that the understanding be in writing, SSARS No. 19 *requires* that the understanding be in writing. For accountants who have established the understanding verbally with their clients in the past, this will be a change in practice and may necessitate discussions with the client.

Accountants should be aware that SSARS No. 19 leaves open the "engagement" that the written understanding should cover. For example, if the accountant is to compile monthly financial statements and then review the year-end financial statements, the accountant can obtain one engagement letter. That letter would cover

[1] [The *applicable financial reporting framework* is the financial reporting framework adopted by management and, when appropriate, those charged with governance in the preparation of the financial statements that is acceptable in view of the nature of the entity and the objective of the financial statements, or that is required by law or regulation. They include, for example, accounting principles generally accepted in the United States, the cash basis of accounting, or the income tax basis of accounting.]

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the entire year. Therefore, SSARS No. 19 does not require a separate engagement letter for the compilation and another letter for the year-end review.

The accountant can even obtain an engagement letter that covers multiple years; however, such documentation is discouraged since the understanding would be less clear as time goes on. It is recommended that the accountant document the understanding with the client's management regarding the services to be performed at least annually.

Enhanced Requirements for Compilation Documentation

Prior to SSARS No. 19, in a compilation engagement, the accountant was only required to document the understanding with the client's management regarding the services to be performed if the accountant availed himself or herself of the nonreporting option provided for compiled financial statements not intended for third-party use and any communications to the appropriate level of management with respect to suspected fraud or illegal acts. SSARS No. 19 expands the documentation requirements for compilation engagements, requiring documentation of the understanding with the client's management regarding the services to be performed for all engagements and any findings or issues that, in the accountant's judgment, are significant. The accountant is still required to document any communications to the appropriate level of management regarding fraud or illegal acts.

A compilation is limited to assisting management in presenting financial information in the form of financial statements without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements for the statements to conform to the applicable financial reporting framework. In the cleanest of compilations, the accountant simply takes the client's data and puts it in the form of financial statements. However, if during the process, the accountant questions whether some of the amounts in the financial statements may be misstated, then those questions and how they're resolved are likely to be significant issues that should be documented. The documentation could be the issue that the accountant raised and management's response to the accountant's inquiry ....

Review Documentation Changes

The documentation procedures for a review engagement are likewise enhanced and expanded. The accountant is now required to document the establishment of an understanding with the client's management regarding the services to be performed for all review engagements.

The accountant is now also required to document management's responses to inquiries regarding fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount. The accountant is required to document the significant matters covered in his or her inquiry procedures and the responses received. This may be accomplished by using a memorandum, checklist, or other means. Any findings or issues that, in the accountant's judgment, are significant must be documented, such as the results of review procedures that indicate the financial statements could be materially misstated, including actions taken to address such findings, and the basis for the final conclusions reached ....

New Compilation and Review Reports

SSARS No. 19 revises the reporting requirements for compilation and review engagements to make the reports clearer as to management's responsibilities and the accountant's responsibility. In addition to the new compilation reporting option when the accountant's independence is impaired, the compilation reporting requirements require a title that clearly indicates that it is the accountant's compilation report. The accountant may indicate that he or she is independent in the title, if appropriate. Examples of appropriate titles would be "Accountant's Compilation Report" or "Independent Accountant's Compilation Report." The report is also required to be addressed as appropriate in the circumstances.

The revised illustrative compilation report splits the report into three clear paragraphs. The introductory paragraph identifies the entity whose financial statements have been compiled; states that the financial statements have been compiled; identifies the financial statements that have been compiled; specifies the date or period covered by the financial statements; and includes a statement that the accountant has not audited

or reviewed the financial statements and, accordingly, does not express an opinion or provide any assurance about whether the financial statements are in accordance with the applicable financial reporting framework.

The second paragraph states management's responsibility for the financial statements and for internal control over financial reporting. The third paragraph states the accountant's responsibility to conduct the compilation in accordance with SSARSs issued by the AICPA and the objective of the compilation. [Refer to the "New Reports for Compilations and Reviews of Financial Statements Ending on or After December 15, 2010" section of this alert to see a comparison of the pre-SSARS No. 19 compilation report and the new report.]

With respect to the review report, SSARS No. 19 requires that the accountant's review report have a title that clearly indicates that it is the accountant's review report and includes the word "independent." An appropriate title would be "Independent Accountant's Review Report." In addition, the accountant's report should be addressed as required by the circumstances of the engagement.

The illustrated review report is separated into four paragraphs. The introductory paragraph identifies the entity whose financial statements have been reviewed, states that the financial statements have been reviewed, identifies the financial statements that have been reviewed, specifies the date or period covered by the financial statements, and includes a statement that a review consists of primarily applying analytical procedures to management's financial data and making inquiries of company management. It also includes a statement that a review is substantially less in scope than an audit, the objective of which is the expression of an opinion regarding the financial statements as a whole, and that, accordingly, the accountant does not express such an opinion.

The second paragraph states management's responsibility for the financial statements and for internal control over financial reporting. The third paragraph states that the accountant's responsibility is to conduct the review in accordance with SSARSs issued by the AICPA, that those standards require the accountant to perform the procedures to obtain limited assurance that there are no material modifications that should be made to the financial statements, and that the accountant believes that the results of his or her procedures provide a reasonable basis for his or her report.

The fourth paragraph states that, based upon his or her review, the accountant is not aware of any material modifications that should be made to the financial statements for them to be in conformity with the applicable financial reporting framework, other than those modifications, if any, indicated in the report. [Refer to the "New Reports for Compilations and Reviews of Financial Statements Ending on or After December 15, 2010" section of this alert to see a comparison of the pre-SSARS No. 19 review report and the new report.]

Changes From April 2009 Exposure Draft

In April 2009, ARSC exposed for public comment a trio of proposed standards that eventually became SSARS No. 19. During the comment period, the committee received 169 comment letters.

SSARS No. 19 differs from the exposure draft in two major ways. First, ARSC decided to retain the concept of *limited assurance* rather than *moderate assurance* as proposed in the exposure draft. ARSC had proposed using the term *moderate assurance* to describe the level of assurance that the accountant aims to obtain in a review engagement in order to harmonize with the terminology used in the international review standards. However, after the exposure draft was issued, the International Audit and Assurance Standards Board began a project to revise the international review standards. ARSC determined that it would be inappropriate to conform to a document currently under revision and, accordingly, tabled the proposed change.

The other major difference is that the proposed nonindependent review is not part of the final standard. ARSC received a number of comments on this proposal, both for and against. As a result of the great interest in this topic, ARSC decided to defer this issue so it could hold additional meetings with key stakeholders. These additional meetings will be used to further discuss with stakeholders the issues that many smaller firm accountants face in trying to serve their small business clients.

At issue is whether performing a nonattest service to help smaller businesses establish or maintain aspects of their internal control over financial reporting, the purpose of which is to improve the reliability of the client's financial statements, impairs an accountant's independence. ARSC will revisit the topic during its public meetings in 2010 but remains committed to allowing practitioners to review financial statements when

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they also perform services that are intended to assist the client in preparing reliable, high-quality financial statements.

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Appendix D—"The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements"

Inquiry—FASB *Accounting Standards Codification* (ASC) 855-10-50-1 states, "An entity shall disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements were issued or the date the financial statements were available to be issued." How does the entity's responsibility to disclose the date through which subsequent events have been evaluated affect the accountant's responsibilities for subsequent events in a compilation or review engagement?

Reply—FASB ASC 855, *Subsequent Events*, does not change the accountant's responsibilities under AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), which states that an accountant performing a review engagement should inquire of members of management who have responsibility for financial and accounting matters concerning events subsequent to the date of the financial statements that could have a material effect on the financial statements. In a compilation engagement, the accountant does not have any responsibility with respect to subsequent events unless evidence or information comes to the accountant's attention that a subsequent event that has a material effect on the financial statements has occurred. When such evidence or information comes to an accountant's attention during a compilation or review engagement, the accountant should request that management consider the possible effects on the financial statements, including the adequacy of any related disclosure. If the accountant determines that a subsequent event is not appropriately accounted for in the financial statements or disclosed in the notes, he or she should follow the guidance in paragraphs .56–.58 of AR section 100 regarding departures from generally accepted accounting principles.

Because the accountant's compilation or review report should be dated as of the completion of the compilation or review procedures, the date of the accountant's compilation or review report can never be earlier than management's subsequent event note date.

In a review engagement, because the accountant is concerned with events occurring through the date of the review report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the accountant's review report.

In most cases, the date that management discloses as the date through which they have evaluated subsequent events (in the notes to the financial statements and, in a review engagement, in the management representation letter) will be the same date as the accountant's compilation or review report. In order to coordinate that these dates (the note date, the representation letter date [in a review engagement], and the accountant's compilation or review report date) are the same, the accountant may want to discuss these dating requirements with management in advance of beginning the compilation or review engagement. The accountant also may want to include, in the accountant's understanding with the client regarding the services to be performed (engagement letter), that management will not date the subsequent event note earlier than the date of management's representations (in a review engagement) and the date of the accountant's compilation or review report.

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Appendix E—"The Accountant's Reporting Responsibility With Respect to Subsequent Discovery of Facts Existing at the Date of the Report"

Inquiry—Paragraphs .77–.82 of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2), provide requirements and guidance when the accountant becomes aware that facts may have existed at the date of the accountant's compilation or review report (or the date of submission of compiled financial statements not intended for third party use in which the accountant does not report) that might have caused him or her to believe that information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had the accountant then been aware of such facts.

Paragraph .79(a) states that when the accountant has concluded that action should be taken to prevent further use of the accountant's report or the financial statements, and the effect on the accountant's report or the financial statements of the subsequently discovered information can promptly be determined,

> disclosure should consist of issuing, as soon as practicable, revised financial statements and, where applicable, the accountant's report. The reasons for the revision usually should be described in a note to the financial statements and, where applicable, referred to in the accountant's report. Generally, only the most recently-issued compiled or reviewed financial statements would need to be revised, even though the revision resulted from events that had occurred in prior years.

What does the term where applicable refer to in paragraph .79(a)?

Reply—The use of the term where applicable refers to a situation in which the accountant has not reported on compiled financial statements not intended for third party use. In the case of a review or a compilation in which the accountant has issued a report, then a revised accountant's report should be issued and the reason for the financial statement's revision usually should be described in the accountant's revised report as well as in a note to the revised financial statements.

[*The next page is 8105.*]

AAM Section 8030

Health Care Industry Developments—2010/11

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Health Care Industry Developments—2009*.

This Audit Risk Alert is intended to provide auditors of financial statements of health care entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully appreciates the invaluable assistance Anne Mundinger provided in creating this publication.

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Mark Albrecht
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Feedback

The Audit Risk Alert *Health Care Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&A Publications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your health care industry audits and also can be used by an entity's internal management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material

misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) explains important issues that affect all entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

The Current Economy

.03 When planning and performing audit engagements, an auditor should understand both the general current economy and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

.04 The year 2010 may be the beginning of a wave of economic recovery. Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. Further, after experiencing a considerable decline in the stock market through March 2009, the markets have rebounded substantially. In March 2009, the S&P 500 and the Dow Jones Industrial Average reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002. By March 2010, only a year later, all 3 had increased in value by at least 59 percent from the previous year's lows. However, all 3 remained relatively unmoved 6 months later, in late September 2010. This exhibits the continuing uncertainty in the markets due to the varying economic indicators, the financial reform regulatory changes, and Europe's economy, among other reasons.

Key Economic Indicators

.05 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.06 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.6 percent in the second quarter of 2010 (second estimate), 3.7 percent in the first quarter of 2010, and 5.6 percent in the fourth quarter of 2009. This data indicates a turnaround in the economy because in the fourth quarter of 2008 and the first quarter of 2009, real GDP decreased 6.3 percent and 5.5 percent, respectively. Further, in June 2010, the Treasury reported that banks had repaid about 75 percent of the bailout money they received through the Troubled Asset Relief Program, and that taxpayers made $21 billion on the investment. However, other bailouts are not yet repaid, and they may yield losses to taxpayers.

.07 From August 2009 to August 2010, the unemployment rate fluctuated between 9.5 percent and 10.1 percent. An unemployment rate of 10.0 percent represents approximately 15.3 million people. The annual

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average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. However, through August 2010, the rate has remained below 10.0 percent.

.08 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent, where it remained through September 2010. The Federal Reserve described the current economic recovery in its September 21, 2010, press release as follows:

- Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software is rising, though less rapidly than earlier in the year, and investment in nonresidential structures continues to be weak.
- Employers remain reluctant to add to payrolls.
- Housing starts are at a depressed level.
- Bank lending has continued to contract, but at a reduced rate in recent months.
- The pace of economic recovery is likely to be modest in the near term.

.09 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant their holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the beginning of the financial market turmoil in August 2007, the Federal Reserve's balance sheet has grown from $869 billion to $2.3 trillion. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

Industry Trends and Conditions

The State of Health Care Entities

.10 A survey conducted by the American Hospital Association (AHA) in March and April 2010 indicated that hospitals are continuing to feel the lingering effects of the economic recession. The survey of 572 nonfederal, short-term acute care hospitals shows the following:

- Eighty-seven percent reported increased bad debt and charity care as a percentage of total gross revenue, and 65 percent reported an increased percentage of patients covered by Medicaid, Children's Health Insurance Program, or other programs.
- Seventy-two percent reported depressed numbers of elective procedures, and 70 percent reported depressed overall patient volumes.
- Seventy-four percent reported reduced operating margins, and 50 percent reported reduced nonoperating income.
- In 2009, in an effort to weather the economic storm, 76 percent had cut administrative costs, 73 percent delayed capital investments, and 53 percent reduced staff. In 2010, 98 percent have not restored services or programs, 89 percent have not added back staff or increased hours, and 67 percent have not started or continued capital projects.

.11 More information about the AHA and the full survey results are available at www.aha.org.

Medical Liability Reform

.12 Hospitals and physicians continue to deal with increasing costs for professional liability insurance. Unaffordable insurance costs are affecting access to care as physicians leave states with high costs or stop providing services that expose them to higher risks of lawsuits. Obstetrics, neurosurgery, and emergency

services are some of the areas of highest concern. Physicians concerned with increasing risk often practice "defensive medicine," which is the practice of providing extra care to minimize lawsuits. The Patient Protection and Affordable Care Act of 2010 (PPACA) appropriated $50 million for demonstration projects that test models aimed at reducing frivolous lawsuits and liability premiums. Medical liability reform is expected to reduce federal mandatory spending on health programs by $41 billion dollars over the next 10 years. Due to the fact that this is generally an area of significant estimates, entities and their auditors need to understand and test liability claims estimates. Assumptions and judgments employed by management should be carefully reviewed and should reflect current environment issues. Auditors need to consider all available remedies for supporting estimates, including the entity's historical experience, attorney confirmations, and available correspondence.

Physician Practice Acquisitions

.13 Industry analysts expect to see a rise in merger and acquisition activity due to the pressures on health care payers and providers brought about by the PPACA. Faced with increased patient volumes at lower levels of reimbursement, more and more physicians are aligning their practices with a hospital or health system.

.14 A major trend exists in cardiology, medical oncology, and many other areas of physician practice acquisitions by hospitals driven by physicians facing reimbursement cuts, as well as difficulty in recruiting young physicians. In many of these transactions, after identification of all intangible assets, a significant amount of goodwill is often recorded by the acquirer. Recording goodwill from such transactions may have a high probability of impairment when the intangible asset values of the practice are based solely on the cost approach to valuation. Acquiring entities and their auditors should carefully review the methodology used to value the physician practices being acquired. Forecasts used to support the valuation assessments need to be reviewed carefully.

.15 New accounting guidance requires not-for-profit (NFP) organizations to test goodwill for impairment at the beginning of the year and at least once annually. Entities have a six month initial application period to complete the first step of a transitional impairment. Evaluation and impairment resulting from this testing is recorded "below the line" as the effect of a change in accounting principle. The transitional evaluation must be completed by the end of the fiscal year of adoption.

.16 Fee-for-service NFPs with previously recognized goodwill will need to

a. establish reporting units based on the entity's internal reporting structure.

b. assign all previously recognized goodwill in each reporting unit as of the beginning of the fiscal year to a transitional impairment evaluation.

c. subject the previously recognized goodwill in each reporting unit as of the beginning of the fiscal year to a transitional impairment evaluation.

d. if the carrying amount of a reporting unit's net assets, including goodwill, exceeds the fair value of that reporting unit, complete the second step of the transitional goodwill impairment test as soon as possible but no later than the end of the fiscal year.

e. reassess useful lives of any previously recognized intangible assets, other than goodwill, and adjust the remaining amortization periods as necessary. The reassessment should be completed before the end of the first interim period of the fiscal year in which the statement is initially applied. Intangible assets deemed to have indefinite useful lives should be tested, and any resulting impairment should be accounted for in the same manner as the procedures outlined for goodwill

.17 In January 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-07, *Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*, which codifies FASB Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions—Including an amendment of FASB Statement No. 142*, primarily in FASB *Accounting Standards Codification* (ASC) 958-805 and FASB

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ASC 958-810. Readers are encouraged to review the full text of FASB Statement No. 164 and ASU No. 2010-07, which are available on the FASB website at www.fasb.org.

Provider Taxes

.18 States have attempted to increase the amount of federal matching funds for which they are eligible by increasing the amount of medical assistance they provide. In order to pay for the increased medical assistance, some states have imposed a tax on health care entities, sought donations or other voluntary payments from them, or both. As a result, the states have been able to generate additional federal matching funds without expending additional state funds.

.19 The accounting for these types of programs is dependent on the individual facts and circumstances. For example, if there is a guarantee that specific monies given to the state by the health care entity will be returned to the entity from the state, those amounts should be recorded as receivables. In addition, if the health care entity has met all the requirements to be legally entitled to additional funds from the state, the revenue or gain should be recognized.

.20 However, if the monies go into a pool with other contributions that are then disbursed based on factors over which the health care entity has little or no control, the payments should be recognized as an expense. Any subsequent reimbursements would be recognized as revenue or gain when the provider is entitled to them and payment is assured.

.21 Auditors should be alert to these issues, and management should be careful to avoid delayed recognition of expenses or improperly recognizing contingent gains.

Medical Resident Federal Insurance Contributions Act Refund Claims

.22 In March 2010, the IRS made an administrative determination to accept the position that medical residents are excepted from Federal Insurance Contributions Act (FICA) taxes for tax periods ending before April 1, 2005, when new IRS regulations went into effect. Although the period of limitations for filing a claim for tax periods before April 1, 2005, has expired, employers (typically hospitals and medical schools) and individual taxpayers (medical residents) began filing FICA refund claims in the 1990s, based on their position that medical residents are students eligible for the FICA tax exception under Internal Revenue Code (IRC) Section 3121(b)(10). This is referred to as the student exception and may apply to a student at a school, college, or university who is also an employee of that school, college, or university. The employer's FICA refund claims were for both the employer share and the employee share of the FICA tax. In some cases, individual medical residents filed their own claim for the employee share of the FICA tax. The IRS held the claims in suspense because there was a dispute about whether the student FICA exception applied.

Legislative and Regulatory Developments

The Health Care and Education Reconciliation Act of 2010 and the PPACA

.23 In March 2010, the president signed into law a sweeping overhaul of the health care system. Almost everyone in the United States will be affected by these changes—individuals, insurance companies, health care providers, and employers. The three primary goals of the reform are to expand coverage to those without health insurance, reform the delivery system of benefits to improve quality, and decrease the costs of providing health care. The various provisions of the reform will become effective over time, through 2020. The new laws contain many changes for employers to consider for financial reporting purposes, in addition to many new tax rules to help offset the overall cost of the reform.

.24 The complete changes are contained in two acts. The Health Care and Education Reconciliation Act of 2010 was signed on March 30 and is a reconciliation bill that amends the PPACA signed into law by the president one week earlier. In April, the Securities and Exchange Commission (SEC) issued a staff announcement, *Accounting for the Health Care and Education Reconciliation Act of 2010 and the Patient Protection and*

Affordable Care Act, to address questions that have arisen about the effect, if any, that the different signing dates might have on accounting for the two acts. This timing difference, related solely to the signing dates, should not have an impact on a majority of registrants because the acts were both signed within a relatively short time period, which for the vast majority of entities, falls into the same reporting period. However, there may be a limited number of registrants with a period-end that falls between the signing dates for which the timing difference could raise questions about whether the different signing dates have an accounting impact.

.25 After consultation with FASB staff, the Office of the Chief Accountant would not object to a view that the two acts should be considered together for accounting purposes. That is, in this specific fact pattern, the SEC staff would not object to a registrant incorporating the effects of the Health Care and Education Reconciliation Act of 2010 when accounting for the PPACA. This view is based in part on the SEC staff's understanding that the two acts, when taken together, represent the current health care reform as passed by Congress and signed by the president. The SEC staff does not believe that it would be appropriate to analogize to this view in any other fact patterns.

Significant Accounting and Tax Considerations

.26 FASB ASC 740-10-30-2 states that the following basic requirements are applied to the measurement of current and deferred income taxes at the date of the financial statements:

- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

.27 FASB ASC 715-60-35-102 further explains that benefit coverage for medical claims by governmental programs or other providers of health care benefits should be assumed to continue as provided by the present law and other providers, pursuant to their present plans. Consistent with FASB ASC guidance, presently enacted changes in the law or amendments of the plans of other health care providers that take effect in future periods and that will affect the future level of their benefit coverage should be considered in current period measurements for benefits expected to be provided in those future periods. Future changes in laws concerning medical costs covered by governmental programs and future changes in the plans of other providers should not be anticipated.

.28 The two primary accounting considerations resulting from this reform are the effects of the tax law changes on deferred income tax balances and other postretirement health benefits. One of the most significant changes relates to the government subsidy for providing qualifying prescription drug coverage to Medicare-eligible retirees becoming an offset for prescription drug income tax deductions. Specifically, because entities will need to reduce their income tax deduction for providing prescription drug coverage by the subsidy received, they currently need to record a charge to earnings to write off a portion of their deferred tax assets related to postretirement health care obligations. Such deferred tax assets were based on the gross liability amount. Because the tax deductible prescription drug costs liability will be reduced by the subsidy, the deferred tax asset will be computed net of the subsidy, resulting in a lower deferred tax asset. The federal subsidy will not reduce the tax deductions until 2013. Even though the changes may not be effective until future periods, the effects are accounted for in the period that includes the enactment date. FASB ASC 715-60 discusses accounting and reporting guidance for other postretirement plans, including the Medicare prescription drug plan. Many public entities have already posted large noncash charges in early 2010 related to the nondeductibility of the subsidy.

.29 Some of the other provisions of the reform that may affect an entity's tax position include the nondeductible pharmaceuticals fee, the medical device excise tax, and the therapeutic discovery project tax credit, which will have an effect on the pharmaceutical and medical device industries. Additionally, employer group health plans may not impose lifetime limits and can only impose "restricted" annual limits beginning with the 2011 plan year (for calendar year plans); no annual limits would be permitted beginning in 2014. Because these health benefits can no longer be limited, entities may need to increase accruals for future

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medical obligations. Many small businesses and tax-exempt organizations that provide health insurance coverage to their employees will now qualify for a special tax credit that is designed to encourage small employers to offer health care coverage for the first time or maintain the coverage they have. Lastly, under the new reform, a 40 percent penalty will apply to tax understatements attributable to transactions lacking economic substance (20 percent with adequate disclosure) or failing to meet the requirements of any similar rule of law. A transaction is treated as having economic substance only if the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

.30 Additional items in the reform that may have favorable consequences for hospitals would include extending coverage for dependent children up to 26 years old, preventing health insurers from excluding children with preexisting conditions, providing access to health coverage through an interim high-risk pool for uninsured adults with preexisting conditions (which will be eliminated in 2014 when the state exchanges will become operational), and prohibiting the termination of existing coverage. Also, beginning in 2014, health insurers will be prohibited from excluding coverage for adults based on preexisting conditions, will have limits imposed on premium ratings, and must guarantee the issuance of coverage for anyone who seeks it.

.31 Other provisions include the following:

- Five-year demonstration grants provided to states to develop, implement, and evaluate alternatives to current tort litigations
- Ten percent Medicare bonus payments for primary care physicians
- Increased Medicaid payments to primary care physicians
- Increased federal oversight to screen procedures provided by providers to reduce fraud
- Reduced annual market basket updates for inpatient hospital, home health, skilled nursing facility, hospice, and other Medicare providers, adjusted for productivity
- Reduced reimbursement for Medicare advantage plans
- Medical loss ratio reports and rebates provided by health plan providers
- Grants provided to states to review and approve premium increases, which require plans to justify increases

.32 Entities will need to fully review the financial impact of the new law and consider disclosing possible future effects.

.33 The full text of these acts can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ152.111.pdf and http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ148.111.pdf.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.34 On July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law. The Dodd-Frank Act was approved by the House on June 30, before narrowly clearing the Senate on July 15. The Dodd-Frank Act will create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisers.

.35 Other requirements and additional information can be found in the full text of this act, which can be found at www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/BILLS-111hr4173ENR.pdf. The AICPA is also following any developments related to the Dodd-Frank Act on our website at www.aicpa.org under "Advocacy—Federal Issues."

PCAOB Constitutionality

.36 On June 28, 2010, the Supreme Court ruled in the lawsuit challenging the constitutionality of the PCAOB. When the PCAOB was set up under SOX, its board members were appointed by the SEC and could be removed only for cause. The Supreme Court ruled in a 5-4 vote that although the manner in which the PCAOB was constituted was constitutionally invalid, SOX itself was not invalidated. Rather, the Supreme Court severed from the rest of SOX the provisions relating to the removal of PCAOB board members. The consequence of the Supreme Court's decision is that PCAOB board members will now be removable by the SEC at will, instead of only for good cause. Essentially, this decision has no material impact on the workings of the PCAOB, and all PCAOB programs will continue to operate as usual, including registration, enforcement, and standard-setting activities.

Municipal Securities Rulemaking Board Activity

.37 The Municipal Securities Rulemaking Board (MSRB) is a self-regulatory organization created by Congress in 1975 to protect investors and the public interest by developing rules for brokers, dealers, and municipal securities dealers (dealers) engaged in municipal securities activities. Under Rule 15c2-12(b)(5) of the Securities Exchange Act of 1934, an underwriter for a primary offering of municipal securities subject to the rule is prohibited from underwriting the offering unless the underwriter has determined that the issuer or an obligated person for whom financial information or operating data is presented in the final official statement has undertaken in writing to provide certain items of information to the MSRB. Rule 15c2-12(b)(5) provides that such items include (*a*) annual financial information concerning obligated persons; (*b*) audited financial statements for obligated persons if available and if not included in the annual financial information; (*c*) notices of certain events, if material; and (*d*) notices of failures to provide annual financial information on or before the date specified in the written undertaking.

.38 In 2009, the MSRB was designated by the SEC as the sole repository of these primary market and continuing disclosure documents. The MSRB's electronic repository and public website for these documents is known as the Electronic Municipal Market Access (EMMA) system.

Pending Proposal Regarding Continuing Disclosures

.39 In December 2009, the MSRB filed with the SEC an amendment to its pending July 2009 filing relating to additional voluntary submissions by issuers and obligated persons to the MSRB's EMMA system.

.40 The proposals would permit issuers to submit preliminary official statements and other primary market documents to EMMA. They would also permit issuers and obligated persons to voluntarily submit information relating to the preparation and submission of audited financial statements and annual financial information and to post links to other disclosure information (see MSRB Notice 2009-63). The MSRB has requested an effective date for the revised proposal to be announced by the MSRB in a notice published on the MSRB website at www.emma.msrb.org. This effective date shall be no later than 9 months after SEC approval of the revised proposal and shall be announced no later than 60 days prior to the effective date.

.41 The proposed December amendment, which revised the July proposal based on comments received by the SEC, would make the following key revisions to the original proposal.

Voluntary Annual Filing Undertaking

.42 The overall purpose of this undertaking is to assist investors and other market participants in understanding when the annual financial information required to be filed by issuers or obligated persons is expected to be available in the future. The original proposal would have consisted of a voluntary undertaking, either at the time of a primary offering or at any time thereafter, that the issuer or obligated person, as appropriate, would submit to EMMA of its annual financial information by no later than 120 calendar days after the end of the fiscal year. In light of the comments received on the July proposal, the MSRB modified the proposal to provide for a transitional option for issuers and obligated persons that would provide them

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the ability to indicate their undertaking to submit to EMMA the annual financial information by no later than 150 calendar days after the end of their fiscal year. However, on and after January 1, 2014, the transitional 150 day undertaking option would no longer be available for selection. An issuer or obligated person that wishes to could make the 120-day undertaking immediately upon the effectiveness of the revised proposal. The MSRB has stated that it contemplates that the making of a voluntary annual filing undertaking through EMMA by an issuer or obligated person would reflect the bona fide intent of the issuer or obligated person to perform as undertaken but would not, by itself, necessarily create a contractual obligation of such issuer or obligated person.

Voluntary Generally Accepted Accounting Principles Undertaking

.43 The overall purpose of this undertaking is to assist investors and other market participants in understanding how audited financial statements were prepared. The fact that an issuer or obligated person has entered into a voluntary generally accepted accounting principles (GAAP) undertaking and the standard under which audited financial statements are to be prepared would be prominently disclosed on the EMMA Web portal as a distinctive characteristic of the securities to which such undertaking applies. The voluntary GAAP undertaking would consist of a voluntary undertaking by an issuer or obligated person, either at the time of a primary offering or at any time thereafter, that the issuer or obligated person will prepare its audited financial statements in accordance with GAAP. In light of the comments received on the original proposal, the MSRB clarified that state or local governments or any other entities to which Governmental Accounting Standards Board (GASB) standards are applicable would apply GAAP as established by GASB and that any other entities to which FASB standards are applicable would apply GAAP as established by FASB.

Centers for Medicare and Medicaid Services Activity

Medicare and Medicaid Electronic Health Record Incentive Programs

.44 The nation's health care system is undergoing a transformation in an effort to improve quality, safety, and efficiency of care. To help facilitate this vision, the Health Information Technology for Economic and Clinical Health Act (HITECH Act) established programs under Medicare and Medicaid to provide incentive payments for the meaningful use of certified electronic health record (EHR) technology.

.45 The HITECH Act is expected to provide $20 billion to be invested in health IT infrastructure to encourage doctors and hospitals to use health IT to electronically exchange patients' health information, while saving $10 billion and generating additional savings throughout the health sector through improvements in quality of care and coordination and through reductions in medical errors and duplicative care.

.46 The Medicare and Medicaid EHR incentive programs will provide incentive payments to eligible professionals and eligible hospitals as they adopt, implement, upgrade, or demonstrate meaningful use of certified EHR technology. The incentive payments begin in 2011. For further information, visit www.cms.gov/EHRIncentivePrograms/.

ePrescribing Incentive Program

.47 The Centers for Medicare & Medicaid Services (CMS) offers eligible providers incentive payments when they use an electronic prescribing (e-prescribing) system to prescribe for Medicare patients. The CMS Electronic Prescribing Incentive Program was authorized by the Medicare Improvements for Patients and Providers Act of 2008, which became law on July 15, 2008. For 2009 and 2010, e-prescribing incentive amounts will be 2 percent of a provider's total estimated allowed charges for covered professional services during the reporting period. The incentive amount reduces to 1 percent in 2011 and finally to 0.5 percent in 2013.

.48 Changes to the program for 2010 include the following:

- Skilled nursing facility and home care are now eligible services.

- Eligible professionals need only report 25 separate electronic prescribing events during the reporting period.
- Eligible professionals will only report one G-code (G8553) that reflects at least one prescription created during the encounter was generated and transmitted electronically using a qualified electronic prescribing system.
- Data may be reported on the 2010 e-prescribing measure through claims, a qualified registry, or a qualified EHR product.

.49 Group practice changes for 2010 include the following:

- Group practices (200 or more eligible professionals) must be selected to participate in the Physician Quality Reporting Initiative (PQRI) group practice reporting option.
- Group practices must report the 2010 e-prescribing measure at least two and one-half times during the reporting period to be considered successful e-prescribers.
- Group practices may choose to report the e-prescribing measure through claims, a qualified registry, or a qualified EHR product.
- Group practices interested in participating in the 2010 PQRI through the group practice reporting option are required to submit a self-nomination letter to the CMS.

.50 For further information visit www.cms.gov.

IRS Activity

The Department of the Treasury and the IRS Issue a Priority Guidance Plan for 2010

.51 Fiscal year 2010 priorities are addressed through a flexible and interdisciplinary array of new tools that focus on enforcement of the tax law and improving customer service. Priorities include the following:

- Issuing guidance on program-related investments of private foundations
- Developing regulations on new excise taxes for donor-advised funds
- Issuing guidance for deferred compensation plans for NFPs
- A further focus on transparency and governance by tax-exempt entities
- Continued implementation of the online compliance guide, known as a *cyber assistant* (which is used to generate IRS Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code," at a reduced user fee)
- Developing regulations regarding the extent to which a limited partner will be considered at risk with respect to liabilities of a partnership, including situations in which a limited partner may be obligated to contribute additional capital to the partnership in the future
- Issuing tax guidance regarding third-party payer issues and reporting agents

.52 Additional information on these and other topics is available at www.irs.gov/pub/irs-utl/2009_-_2010_priority_guidance_plan_initial.pdf.

New Health Insurance Tax Credit for Exempt Organizations

.53 Effective for tax year 2010, many small businesses and tax-exempt organizations that provide health insurance coverage to their employees now qualify for a special tax credit. Included in the health care reform legislation, the PPACA is a credit designed to encourage small employers to offer health care coverage for the first time or maintain their current coverage.

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.54 To be eligible for the credit, a qualifying employer must cover at least 50 percent of the cost of health care coverage for some of its workers, based on the rate for single person coverage. A qualifying employer also must have less than the equivalent of 25 full-time workers (for example, an employer with fewer than 50 half-time workers may be eligible) and must pay average annual wages below $50,000 per full-time equivalent position.

.55 The credit is worth up to 35 percent of a small business's premium costs (25 percent for NFPs) in 2010. On January 1, 2014, this rate increases to 50 percent (35 percent for NFPs) but is subject to a phaseout. The credit phases out for entities with average wages between $25,000 and $50,000 and for entities with the equivalent of between 10 and 25 full-time workers.

.56 In September 2010, the IRS released a draft version of Form 8941, "Credit for Small Employer Health Insurance Premiums," which small businesses and tax-exempt organizations will use to calculate the small business health care tax credit when they file income tax returns next year. Small businesses will include the amount of the credit as part of the general business credit on their return, and tax-exempt organizations will claim the credit on a revised Form 990-T, "Exempt Organization Business Income Tax Return (and proxy tax under Section 6033(e))." For further information, visit www.irs.gov.

New Employment Tax Credits for Exempt Organizations

.57 Two new tax benefits are now available to nongovernmental employers hiring workers who were previously unemployed or only working part time. These provisions are part of the Hiring Incentives to Restore Employment Act that was enacted into law in March 2010.

.58 Employers who hire unemployed workers after February 3, 2010, and before January 1, 2011, may qualify for a 6.2 percent payroll tax incentive, in effect exempting them from their share of Social Security taxes on wages paid to these workers after March 18, 2010. This reduced tax withholding will have no effect on the employee's future Social Security benefits, and employers would still need to withhold the employee's 6.2 percent share of Social Security taxes, as well as income taxes. The employer's and employee's share of Medicare taxes also would still apply to these wages.

.59 In addition, for each worker retained for at least 1 year, employers may claim an additional general business tax credit up to $1,000 per worker when they file their 2011 income tax returns.

.60 New hires filling existing positions also qualify but only if the workers they are replacing left voluntarily or for cause. Family members and other relatives do not qualify.

.61 In addition, the new law requires that the employer get a statement from each eligible new hire certifying that he or she was unemployed during the 60 days before beginning work or, alternatively, worked less than a total of 40 hours for someone else during the 60-day period. The IRS currently is developing a form that employees can use to make the required statement.

.62 Employers claim the payroll tax benefit on the federal employment tax return they file, usually quarterly, with the IRS. Eligible employers will be able to claim the new tax incentive on their revised employment tax form for the second quarter of 2010. Revised forms and further details on these two new tax provisions will be posted on www.irs.gov.

Internet-Based Workshop for Exempt Entities

.63 The IRS has an Internet-based version of its popular "Exempt Organizations Workshop" covering tax compliance issues confronted by small and midsized tax-exempt entities.

.64 The free online workshop, "Stay Exempt—Tax Basics for Exempt Organizations," consists of the following five interactive modules on tax compliance topics for exempt entities:

- *Tax-Exempt Status.* How can you keep your 501(c)(3) exempt?

- *Unrelated Business Income.* Does your entity generate taxable income?
- *Employment Issues.* How should you treat your workers for tax purposes?
- *Form 990.* Would you like to file an error-free return?
- *Required Disclosures.* To whom do you have to show your records?

.65 Users can access this new training program at www.stayexempt.org. Users can complete the modules in any order and repeat them as many times as they like. The online training website does not require registration, and its visitors will remain anonymous. The workshop can be found at www.stayexempt.org/Virtual-Workshop.aspx.

Resource Materials—Compliance Initiatives for Tax-Exempt Entities

.66 The Exempt Organizations Division of the IRS has made materials available that were used in, or which discuss, its compliance initiatives, including limited liability company projects, community foundations, bond compliance, hospitals, and executive compensation. You can find this material at www.irs.gov/charities/article/0,,id=162493,00.html.

Listing of Published Guidance—2010

.67 Readers should be aware that the IRS website contains a digest of published guidance for tax-exempt entities issued in 2010 at www.irs.gov/charities/content/0,,id=202419,00.html. The published guidance includes treasury regulations, revenue rulings, revenue procedures and notices, and announcements of recently published issues of interest to tax-exempt entities.

.68 The IRS website also contains an archive that presents digests of IRS-published guidance of interest to tax-exempt entities for the years 1954–2009. The archived guidance can be found at www.irs.gov/charities/article/0,,id=151053,00.html. Additionally, the IRS has a useful tool for NFPs to assist them in maintaining their tax-exempt status through compliance with IRS requirements. The publication *Compliance Guide for 501(c)(3) Public Charities* is available at www.irs.gov/pub/irs-pdf/p4221pc.pdf.

IRS Notice 2010-39, **Request for Comments Regarding Additional Requirements for Tax-Exempt Hospitals**

.69 IRS Notice 2010-39, *Request for Comments Regarding Additional Requirements for Tax-Exempt Hospitals*, solicits comments regarding the application of certain requirements imposed by new Section 501(r) added to the IRC by section 9007(a) of the PPACA. This section affects hospital organizations that are currently described in Section 501(c)(3) of the IRC as exempt from federal income taxation.

.70 New Section 501(r)(1) imposes four additional requirements that hospital organizations must satisfy to be described as tax exempt: (*a*) conducting a community health needs assessment every three years and adopting an implementation strategy to meet the needs identified through the assessment, (*b*) establishing a financial assistance policy and a policy relating to emergency care, (*c*) certain limitations on amounts charged for emergency or other medically necessary care to individuals eligible for assistance, and (*d*) certain restrictive requirements for collection processes on individuals who may be eligible for financial assistance.

.71 The PPACA also added new Section 4959, which imposes an excise tax for failures to meet certain of the new Section 501(r) requirements, and reporting requirements under Section 6033(b) related to Sections 501(r) and 4959.

.72 Readers should be aware of the final ruling available at www.irs.gov.

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New Filing and Audit Requirements for Employee Retirement Income Security Act-Covered Section 403(b) Employee Benefit Plans

.73 Beginning in 2009, employee benefit plans sponsored by charitable entities and schools under IRC Section 403(b) and covered under the Employee Retirement Income Security Act of 1974 (ERISA) were subject to the same reporting and audit requirements as Section 401(k) plans. Section 403(b) plans also are commonly known as *tax-shelter annuity plans*. Under Department of Labor (DOL) regulations issued in November 2007 amending the filing requirements for Form 5500, "Annual Return/Report of Employee Benefit Plan," ERISA-covered Section 403(b) plans with 100 or more participants generally are required to file audited financial statements beginning with their 2009 Form 5500 filing. Section 403(b) plans with fewer than 100 participants are eligible to use abbreviated reporting forms without audited financial statements. The DOL estimates that approximately 7,000 Section 403(b) plans are subject to the new audit requirements, and another 9,000 Section 403(b) plans will be eligible for the waiver. The DOL regulations were published in the November 16, 2007, *Federal Register* and are available at www.dol.gov/ebsa/regs/fedreg/final/20071116.pdf. The AICPA Employee Benefit Plan Audit Quality Center (www.aicpa.org/EBPAQC) and Expert Panel have formed a joint task force to develop resources to help members with these audit requirements.

Red Flags Rule

.74 In October 2007, the Federal Trade Commission (FTC) issued the Red Flags Rule for financial institutions and creditors to fight identity theft. The rule sets out how certain businesses and organizations must develop, implement, and administer their identity theft prevention programs. These programs must include the following four basic elements, which, together, create a framework to address the threat of identity theft:

- The program must include reasonable policies and procedures to identify the red flags of identity theft that may arise in the day-to-day operation of your business. *Red flags* are suspicious patterns or practices or specific activities that indicate the possibility of identity theft. For example, if a customer has to provide some form of identification to open an account with an entity, an ID that looks like it might be fictitious would be a red flag.
- The program must be designed to detect the red flags that have been identified. For example, if an entity has identified fake IDs as a red flag, it must have procedures in place to detect possible fake, forged, or altered identification.
- The program must spell out appropriate actions to take when red flags are detected.
- The program must address how the program will be reevaluated periodically to reflect new risks from this crime because identity theft is an ever-changing threat.

.75 The program must state who is responsible for implementing and administering it effectively. Because employees have a role to play in preventing and detecting identity theft, the program also must include appropriate staff training. The program also must address the manner in which contractors will be monitored when outsourcing or subcontracting functions of operations that would be covered by the rule.

.76 The Red Flags Rule applies to financial institutions and creditors. The rule requires a periodic risk assessment to determine if the entity has covered accounts. A written program needs to be in place only if the entity has covered accounts. It is important to look closely at how the rule defines *financial institution* and *creditor* because the terms apply to groups that typically might not use those words to describe themselves. For example, many NFPs and government agencies are creditors under the rule.

.77 The Red Flags Rule does not name specific types of organizations that must comply; however, for NFP organizations, compliance requirements are based on the types of accounts that the institution has with its customers and clients. Examples include (*a*) payment plans for tuition at a college or university or (*b*) club dues of an NFP that are allowed to be paid in installments. Because of their creditor status in these situations, the Red Flags Rule applies.

.78 The FTC suspended enforcement of the new Red Flags Rule until June 10, 2010. After June 10, 2010, any instance of identity theft exposes the NFP organization to an FTC investigation.

.79 More information and a document outlining specific requirements of the Red Flags Rule can be found at http://ftc.gov/redflagsrule.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.80 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some risks that may affect an entity in the current economic environment are as follows:

- Marginally achieving explicitly stated strategic objectives
- Volatile real estate and business markets
- Significant measurement uncertainty, including accounting estimates and fair value measurements
- Potentially erroneous or fraudulent activity due to decreased staffing and resurgence of business activity
- The continuing evolution of the postrecessionary marketplace

.81 Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

.82 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

PCAOB Auditing Standards on Risk Assessment

.83 In August 2010, the PCAOB adopted a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit. These standards were initially proposed in late 2008 and reproposed in late 2009. These risk assessment standards will benefit investors by setting forth requirements that enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. They are applicable to audit procedures spanning from the initial planning stages of the audit to the evaluation of the audit results. Improvements in the risk assessment standards should enhance integration of the audit of financial statements with the audit of internal control over financial reporting by articulating a process for identifying and assessing risks of material misstatements that apply to both portions of the integrated audit.

.84 The new auditing standards, with a brief description of each, are as follows:

- Auditing Standard No. 8, *Audit Risk*, discusses the auditor's consideration of audit risk in both an integrated audit and an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing it to an appropriately low level.
- Auditing Standard No. 9, *Audit Planning*, establishes requirements for planning an audit, such as assessing important matters and establishing an appropriate audit strategy.

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- Auditing Standard No. 10, *Supervision of the Audit Engagement*, is applicable to the engagement partner and other team members who supervise during the audit. It sets forth requirements for supervision of the audit engagement and the work of other engagement members. Related to this topic, the PCAOB also recently issued a release discussing the provision of SOX that authorizes the PCAOB to impose sanctions on registered public accounting firms and their supervisory personnel for failing to reasonably supervise associated persons.
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements for auditors in identifying and assessing risks of material misstatement, including information-gathering procedures.
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements for responding to those identified risks of material misstatement through general audit procedures. It also includes audit procedures related to significant accounts and disclosures.
- Auditing Standard No. 14, *Evaluating Audit Results*, establishes requirements for evaluating audit results and the sufficiency of appropriate audit evidence.
- Auditing Standard No. 15, *Audit Evidence*, discusses what constitutes audit evidence and how to design and perform audit procedures to support the opinion expressed in the auditor's report.

.85 These risk assessment standards will supersede the following six PCAOB interim standards and related amendments: AU section 311, *Planning and Supervision*; AU section 312, *Audit Risk and Materiality in Conducting an Audit*; AU section 313, *Substantive Tests Prior to the Balance Sheet Date*; AU section 319, *Consideration of Internal Control in a Financial Statement Audit*; AU section 326, *Evidential Matter*; and AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). The standards, if approved by the SEC, will be effective for audits of fiscal periods beginning on or after December 15, 2010.

Engagement Quality Review for Issuers

.86 In January 2010, the PCAOB announced that the SEC had approved Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which was adopted by the PCAOB in July 2009. Auditing Standard No. 7 provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. Auditing Standard No. 7 is expected to increase the likelihood that a registered public accounting firm will catch any significant deficiencies before it issues its audit report. As a result, more work may be necessary under this standard than performed under the existing requirements for concurring partners. However, Auditing Standard No. 7 explains that the procedures required by the engagement quality reviewer are different in nature than those required to be performed by the engagement team. Further, if the engagement quality reviewer deems more work is required before giving approval of issuance, the engagement team is responsible for completing that work.

.87 This standard applies to all audit engagements, and engagements to review interim financial information, conducted pursuant to the standards of the PCAOB, and it supersedes the PCAOB's interim concurring partner review requirement. Auditing Standard No. 7 is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009. For a public, calendar-year company, this standard is applicable for the quarter ended March 31, 2010. Subsequent to the issuance of Auditing Standard No. 7, the PCAOB issued Staff Question and Answer, *Auditing Standard No. 7,* Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10), to provide further implementation guidance on the documentation requirements of the standard. For the full text of the standard and the question and answer, readers are encouraged to visit the PCAOB's website at www.pcaob.org.

Supplementary and Other Information Related to Financial Statements

.88 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU section 550A, *Other Information in Documents Containing Audited Financial Statements*; AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.89 Statement on Auditing Standards (SAS) No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information. *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

Supplementary Information in Relation to the Financial Statements as a Whole

.90 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of generally accepted auditing standards (GAAS), *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

.91 The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This SAS also may be applied, with the report wording adapted as necessary, when an auditor has been engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Required Supplementary Information

.92 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558), addresses the auditor's responsibility with respect to *required supplementary information*. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and

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presentation of the information have been established. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. SAS No. 120 explains that the objectives of the auditor, when a designated accounting standard setter requires information to accompany an entity's basic financial statements, are to perform specified procedures in order to

- describe, in the auditor's report, whether required supplementary information is presented and
- communicate therein when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter.

Auditing Fair Value Measurements

.93 In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with U.S. GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

.94 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB ASC 820, *Fair Value Measurements and Disclosures*, under U.S. GAAP this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.
- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)

- The reasonableness of the determination within the fair value hierarchy of inputs.

Fair Values of Securities

.95 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB ASC 820, quoted prices in active markets are considered level 1 inputs.

.96 When an entity performs its own valuation, value testing procedures include the following:

- Assessing the reasonableness
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

.97 Whether the inputs to the entity's valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB ASC 820. When extensive judgment is needed, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.98 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles. The auditor also should evaluate management's conclusions regarding other-than-temporary impairment on its securities. Examples of factors that could cause an other-than-temporary impairment, per paragraph .47 of AU section 332, include the following:

- Fair value is significantly below cost and
  - — the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - — the decline has existed for an extended period of time.
  - — management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

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.99 Auditors should consider all facts and circumstances when determining if an other-than-temporary impairment has occurred. Additionally, the classification of an entity's securities is based on management's intent and ability. The auditor should obtain an understanding of management's classification process among trading, available-for-sale, and held-to maturity, as well as consider the classifications in light of the entity's current financial position.

Auditing Accounting Estimates

.100 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, impairment analysis and estimated useful lives of long lived assets, valuation allowance for deferred tax assets, and actuarial assumptions in pension and other postretirement benefit costs.

.101 Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

.102 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet earnings, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management's accounting estimates with an extra degree of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.103 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342. The AICPA has released a proposed redrafted SAS, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* (Redrafted), on auditing accounting estimates, including fair value. Readers are encouraged to remain alert for developments on this topic.

Using the Work of a Specialist

.104 It may be necessary to use a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.

.105 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements. In July 2010, the PCAOB issued Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06), because it observed that a number of registered public accounting firms located in the United States have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the United States. Auditors of issuers should consult this practice alert for reminders concerning their obligations when using the work of other firms or using assistants engaged from outside the firm, such as in the aforementioned situation.

Communicating Internal Control Related Matters Identified in an Audit

.106 SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), supersedes SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, and further clarifies standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted.

.107 The SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion), except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1). In general, SAS No. 115 retains many of the provisions of SAS No. 112. The key differences between the two standards lie in the definitions of *material weaknesses* and *significant deficiencies*.

Definitions of Significant Deficiency *and* Material Weakness

.108 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable*, as those terms are defined in the FASB ASC glossary. The FASB ASC glossary defines *reasonably possible* as when the chance of the future event or events occurring is more than remote but less than likely; *probable* is defined as when the future event or events are likely to occur. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

The Evaluation Process

.109 Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. Further, the severity of a deficiency does not depend on whether a misstatement actually occurred.

.110 The AICPA published the Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) to assist in understanding the requirements of this

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SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Service Organizations

.111 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324) has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801), contains the requirements for reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324. Once the new SAS becomes effective, it will replace the guidance for user auditors currently in AU section 324. SSAE No. 16 is based on the International Auditing and Assurance Standards Board's (IAASB's) International Standard on Assurance Engagements No. 3402, *Assurance Reports on Controls at a Service Organization*, and the new SAS is based on the IAASB's International Standard on Auditing (ISA) 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

.112 The AICPA is in the process of overhauling and rewriting the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (commonly known as the SAS 70 guide). Also, to address reporting on a service provider's controls over subject matter other than financial reporting, the AICPA is developing a new Audit Guide, *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*. Both guides are expected to be available for sale in early 2011. The AICPA is also in the process of drafting communication materials that will help auditors, clients, and users understand the three types of service organization control (SOC) reports (formerly SAS No. 70 reports) to be used for reporting on these engagements.

	Title	***Description***
SOC 1	*Report on Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting*	To be used only in circumstances when the service organization's services and controls affect the internal control over financial reporting for the entities that use the service.
SOC 2	*Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, and Privacy*	The purpose is to convey trust and assurance to users of the system that the service organization has deployed an effective control system to effectively mitigate operational and compliance risks that the system may represent to its users.
SOC 3	*Trust Services Report*	These reports are designed to meet the needs of users who want assurance on the controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy of a system but do not have the need for the level of detail provided in an SOC 2 report. These reports are general use reports and can be freely distributed or posted on a website as a seal.

Compilation and Review Engagements

.113 The AICPA developed a brand new guide, *Compilation and Review Engagements*, which provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

Accounting Issues and Developments

.114 Given the current economic climate, auditors should consider a number of accounting and financial reporting issues, such as the following:

- Fair value, including fair value measurements in illiquid markets
- Impairment

Presentation of Insurance Claims and Related Recoveries

.115 In August 2010, FASB issued ASU No. 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the Emerging Issues Task Force)*, to address current diversity in practice related to the accounting by health care entities for medical malpractice claims and similar liabilities and their related anticipated insurance recoveries. Most health care entities have netted anticipated insurance recoveries against the related accrued liability, although some have presented the anticipated insurance recovery and related liability on a gross basis.

.116 The amendments in ASU No. 2010-24 are consistent with the guidance on netting receivables and payables in FASB ASC 210-20 that is more broadly applicable for entities in other industries and that does not permit offsetting of conditional or unconditional liabilities with anticipated insurance recoveries from third parties.

.117 ASU No. 2010-24 clarifies that a health care entity should not net insurance recoveries against a related claim liability, and the claim liability should be determined without consideration of insurance recoveries.

.118 The amendments in ASU No. 2010-24 are effective for fiscal years beginning after December 15, 2010, and interim periods within those fiscal years. A cumulative-effect adjustment should be recognized in opening retained earnings in the period of adoption if a difference exists between any liabilities and insurance receivables recorded as a result of application. Retrospective and early application are permitted.

Measuring Charity Care for Disclosure

.119 In August 2010, FASB issued ASU No. 2010-23, *Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*, to reduce the diversity in practice regarding the measurement basis used in the disclosure of charity care. Some entities determine their charity care disclosures on the basis of a cost measurement, and others use a revenue measurement.

.120 ASU No. 2010-23 requires that cost be used as the measurement basis for charity care disclosure purposes and that cost be identified as the direct and indirect costs of providing charity care. Because various techniques will likely be used to determine how the direct and indirect costs are identified, such as obtaining the information directly from a costing system or through reasonable estimation techniques, ASU No. 2010-23 also requires the disclosure of the method used to identify or determine costs.

.121 The amendments of ASU No. 2010-23 are effective for fiscal years beginning after December 15, 2010, and should be applied retrospectively. Early application is permitted.

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FASB Statement No. 168

.122 FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, as codified in FASB ASC 105, *Generally Accepted Accounting Principles*, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in their financial statements.

Referencing FASB ASC in Your Documentation

.123 You should consider how your entity will reference FASB ASC in your documentation (policy and procedures, technical memorandums, financial statements and filings, engagement working papers, and so on). It is only prudent to reflect current U.S. GAAP in your documentation. The FASB Notice to Constituents (NTC) includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*." Conversely, FASB suggests using the detailed numerical referencing system in working papers, articles, textbooks, and related items.

.124 Also, because FASB ASC is not intended to change U.S. GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate. It is prudent to expect that audit, attest, or compilation and review working papers associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

.125 However, if your entity will continue to follow grandfathered guidance not included in FASB ASC, it would still be appropriate to reference those standards (and not FASB ASC). A listing of examples of grandfathered guidance can be found in FASB Statement No. 168.

.126 Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/FASBAccountingStandardsCodification.aspx.

Decreases in Ownership of a Subsidiary

.127 In January 2010, FASB issued ASU No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*. This ASU addresses implementation issues related to the changes in ownership provisions in FASB ASC 810-10 (issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*). These amendments clarify that the scope of the decrease in ownership provisions of FASB ASC 810-10 and related guidance applies to a subsidiary or group of assets that is a business or nonprofit activity, a subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture, and an exchange of a group of assets that constitutes a business or nonprofit activity for a noncontrolling interest in an entity (including an equity method investee or joint venture). Further, the amendments clarify that the decrease in ownership guidance in FASB ASC 810-10 does not apply to the following transactions, even if they involve businesses: sales of in-substance real estate and conveyances of oil and gas mineral rights. The amendment also expands the required disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of FASB ASC 810-10. This ASU is effective beginning in the period that an entity adopts FASB

Statement No. 160. If an entity has already adopted this guidance, then the amendments in this ASU are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this ASU should be applied retrospectively to the first period that an entity adopted FASB Statement No. 160.

Accounting for Uncertainty in Income Taxes

.128 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities, and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.
- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt NFP, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FASB ASC 740-10-50-15[a]–[b]).

.129 For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009.

Consolidation of Variable Interest Entities

.130 For calendar year entities, 2010 is the first year of application of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB Statement No. 167 was incorporated into FASB ASC through ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited.

.131 The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This statement also amends consolidation of variable interest entities (VIE) guidance to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

.132 Entities will be required to provide additional disclosures about involvement with VIEs and any significant changes in risk exposure due to that involvement. Entities also will be required to disclose how involvement with a VIE affects the entity's financial statements.

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.133 FASB Statement No. 167 retains the scope of previous VIE consolidation accounting guidance, with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, which was incorporated into FASB ASC by ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*.

.134 This statement also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a VIE or disclose information about its involvement in a VIE, or both
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks associated with an enterprise's involvement with the VIE
- How an enterprise's involvement with the VIE affects the enterprise's financial position, financial performance, and cash flows

Accounting for Transfers of Financial Assets

.135 Calendar year entities must also start applying the provisions of FASB Statement No. 166 in 2010. FASB Statement No. 166, which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, requires more information about transfers of financial assets, including securitization transactions, and those circumstances in which entities have continuing exposure to the risks related to transferred financial assets. FASB Statement No. 166 was incorporated into FASB ASC by ASU No. 2009-16 and is discussed in FASB ASC 860, *Transfers and Servicing*. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. It is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

.136 Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance.

.137 The primary objectives of the disclosure requirements of this guidance are to provide the financial statement users with a clear understanding of the following:

- A transferor's continuing involvement (as defined by the FASB ASC glossary), if any, with transferred financial assets
- The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- How servicing assets and servicing liabilities are reported under this pronouncement
- For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how

the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows

.138 These objectives must be met by the disclosures, regardless of the specific requirements of the pronouncement. It may be the case that an entity provides greater detail than what is a required disclosure to meet these objectives, depending on the facts and circumstances.

Subsequent Events

.139 FASB Statement No. 165, *Subsequent Events*, which has been codified in FASB ASC 855, *Subsequent Events*, is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued). The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

.140 In particular, this statement sets forth the following:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

.141 FASB states that this guidance should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. In September 2009, the AICPA issued Technical Questions and Answers (TIS) section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), which notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. This question and answer can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

.142 In February 2010, FASB issued ASU No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, to address questions that arose in practice about potential conflicts between FASB ASC 855 and SEC guidance—specifically, the requirements to disclose the date that the financial statements are issued. This ASU also addresses the intended breadth of the reissuance disclosure provision related to subsequent events.

.143 ASU No. 2010-09 requires an entity that is an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market to evaluate subsequent events through the date the financial statements are issued. All other entities must evaluate subsequent events through the date the financial statements are available to be issued. Further, an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. Lastly, only non-SEC filers should disclose in the revised financial statements the dates through which subsequent events have been evaluated in both the issued or available-to-be-issued financial statements and the revised financial statements. Revised financial statements are considered reissued financial statements.

.144 The amendments in ASU No. 2010-09 are effective upon issuance, except for the use of the issued date for conduit bond obligors. That amendment is effective for interim or annual periods ending after June 15,

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2010. In June 2010, the AICPA issued TIS section 8700.03, "Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor" (AICPA, *Technical Practice Aids*), to provide guidance related to the effect of this ASU on the auditor's responsibilities for subsequent events relative to a conduit debt obligor and the date of the auditor's report.

Fair Value

.145 FASB ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity. *Fair value* is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Measuring Liabilities at Fair Value

.146 FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value*, to increase the consistency in the application of FASB ASC 820 to liabilities because many constituents had expressed concern. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10.

.147 This ASU states that, in circumstances in which a quoted price in an active market for the identical liability is not available, fair value of the liability must be measured by either (*a*) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities, or similar liabilities when traded as assets, or (*b*) another valuation technique that is consistent with the principles of FASB ASC 820, such as an income approach or a market approach. Further, if a restriction on the transference of the liability exists, the ASU clarifies that an entity is not required to factor that in to the inputs of the fair value determination. Lastly, the ASU also clarifies that a quoted price in an active market for the identical liability, or an unadjusted quoted price in an active market for the identical liability, when traded as an asset, are level 1 measurements within the fair value hierarchy. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after its issuance in August 2009. The full text of the ASU can be accessed from FASB's website at www.fasb.org.

Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

.148 FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both

- does not have a *readily determinable fair value*. The FASB ASC glossary states that an equity security has a readily determinable fair value if it meets any of the following conditions:
    - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the over-the-counter (OTC) market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year.
    - The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.
    - The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes are not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies*.

.149 As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the net asset value (NAV) per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

.150 This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU regardless of whether the practical expedient has been applied. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

.151 These amendments are effective for interim and annual periods ending after December 15, 2009 and are included in FASB ASC 820-10. An AICPA practice aid, *Alternative Investments—Audit Considerations*, also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments.

.152 In December 2009, the AICPA issued sections .18–.27 of TIS section 2220, *Long-Term Investments* (AICPA, *Technical Practice Aids*), to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers compliment the guidance provided in ASU No. 2009-12.

.153 Topics covered in these questions and answers include the following:

- The circumstances when NAV may be used to estimate the fair value of investments as a practical expedient
- How to identify the unit of account for interests in alternative investments
- Considerations for determining whether the reported NAV has been calculated in a manner consistent with FASB ASC 946
- Examples of circumstances when an adjustment to the reported NAV may be necessary
- How to adjust the reported NAV when it is not as of the reporting entity's measurement date
- How to adjust the reported NAV when it has not been calculated in accordance with FASB ASC 946
- The determination of the appropriate level within the fair value hierarchy for NAV of alternative investments in relation to the ability to redeem the investment versus the actual redemption request for the investment
- The definition of *near term* for the purposes of determining the appropriate level within the fair value hierarchy
- The tailoring of disclosures categories to address the nature and risks of investments
- Some considerations for determining the fair value of alternative investments when not utilizing NAV as a practical expedient

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.154 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurements Disclosures

.155 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers between the three levels and the underlying reasons for such transfers would be useful to financial statements users.

.156 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.157 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.158 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Disclosures About Credit Quality and Allowance for Credit Losses

.159 In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. The ASU amends the existing disclosures to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis:

- A rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method. For each disaggregated ending balance, the related recorded investment in financing receivables should also be disclosed.
- The nonaccrual status of financing receivables by class of financing receivables.
- Impaired financing receivables by class of financing receivables.

.160 The amendments in this ASU require an entity to provide the following additional disclosures about its financing receivables:

- Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables (see FASB ASC 310-10-55-19 for examples of credit quality indicators)
- The aging of past due financing receivables at the end of the reporting period by class of financing receivables
- The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment

.161 An entity must also describe, by portfolio segment, its accounting policies and methodology used to estimate its allowance for credit losses, including the identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

.162 The amendments in this ASU apply to all entities with financing receivables. Examples of financing receivables include loans; trade receivables; notes receivable; and receivables relating to a lessor's leveraged, direct financing, and sales-type leases. See the "Pending Content" in paragraphs 13–15 of FASB ASC 310-10-55 for more information on the definition of *financing receivable*, including a list of items that are excluded from the definition (for example, debt securities). In addition, the "Pending Content" in paragraphs 7–12 of FASB ASC 310-10-55 illustrates certain disclosures required by this ASU.

.163 For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

Recently Issued GASB Pronouncements and Related Guidance

.164 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard.

GASB Statement No. 58, Accounting and Financial Reporting for Chapter 9 Bankruptcies

.165 The objective of GASB Statement No. 58, which was issued in December 2009 and is effective for reporting periods beginning after June 15, 2009, is to provide accounting and financial reporting guidance for governments that have petitioned for protection from creditors by filing for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code. It requires governments to remeasure liabilities that are adjusted in bankruptcy when the bankruptcy court confirms (that is, approves) a new payment plan.

.166 For accounts payable, notes, debentures and bonds, and related interest payable, this statement requires governments to base remeasurement on the new payment plan. Reductions in future interest payments would result in lower interest costs reported in future periods. Reductions to principal or accrued interest payable may result in gains reported at the time of the reduction. If the new payment plan does not indicate whether it reduces principal payments or future interest payments that have not been accrued, the debt should be remeasured at the present value of the future payments using the original discount rate, and a gain should be reported at the time of the reduction.

.167 For leases, pollution remediation liabilities, and liabilities for pension and other postemployment benefit plans, this statement requires remeasurement based on existing authoritative guidance. However, if a benefit plan is rejected in bankruptcy and becomes general unsecured debt, GASB Statement No. 58 requires

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the existing liability to be removed and a new approved payment plan to be recognized as a judgment, with a gain or loss recognized for the difference. Gains or losses resulting from remeasurement of liabilities and assets should be classified as an extraordinary item.

.168 For governments that are not expected to emerge from bankruptcy as going concerns, this statement requires remeasurement of assets to a value that represents the amount expected to be received.

.169 Governments that have filed for bankruptcy are required to disclose information regarding, among other things, the pertinent conditions and events giving rise to the petition for bankruptcy, the expected gain, and the effects upon services.

GASB Statement No. 57, OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans

.170 Issued in December 2009, GASB Statement No. 57 addresses issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer other postemployment benefit (OPEB) plans (that is, agent employers).

.171 This statement amends GASB Statement No. 45, *Accounting and Financial Reporting by Employers to Postemployment Benefits Other Than Pensions*, to permit an agent employer that has an individual-employer OPEB plan with fewer than 100 total plan members to use the alternative measurement method at its option, regardless of the number of total plan members in the agent multiple-employer OPEB plan in which it participates. Consistent with this change to the employer-reporting requirements, this statement also amends a GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, requirement that a defined benefit OPEB plan obtain an actuarial valuation. The amendment permits the requirement to be satisfied for an agent multiple-employer OPEB plan by reporting an aggregation of results of actuarial valuations of the individual-employer OPEB plans or measurements resulting from the use of the alternative measurement method for individual-employer OPEB plans that are eligible.

.172 In addition, GASB Statement No. 57 clarifies that when actuarially determined OPEB measures are reported by an agent multiple-employer OPEB plan and its participating employers, those measures should be determined as of a common date and at a minimum frequency to satisfy the agent multiple-employer OPEB plan's financial reporting requirements.

.173 The provisions related to the use and reporting of the alternative measurement method are effective upon issuance. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011.

Convergence With International Financial Reporting Standards

.174 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and International Financial Reporting Standards (IFRSs) and eliminate the differences between them. In the Norwalk agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

SEC Work Plan for Consideration of IFRSs

.175 In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to the SEC's roadmap on its consideration of global accounting standards, including a confirmation of its continued support for the convergence of U.S. GAAP and IFRSs in order to narrow the differences between the two sets of standards. The SEC believes that a more comprehensive work plan is necessary to transparently lay out the work that must be done to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, time frame, and methodology for any such transition. Therefore, the SEC has indicated that it will carefully consider and deliberate whether these changes are in the best interest of U.S. investors and markets.

.176 The SEC directed its staff to execute a work plan, the results of which will aid the SEC in its evaluation of the impact that the use of IFRSs by U.S. entities would have on the U.S. securities market. The work plan includes consideration of IFRSs, both as they currently exist and after the completion of the various convergence projects underway by FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received on the roadmap, including the following:

- Sufficient development and application of IFRSs for the U.S. reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRSs
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

.177 Beginning no later than October 2010, and frequently thereafter, the SEC staff will provide public progress reports on the work plan, as well as the status of the FASB and IASB convergence projects, until the work is complete. By 2011, assuming completion of these convergence projects and the staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. Commentors provided feedback on the timing discussed in the roadmap, suggesting that a four or five year time frame would be necessary to successfully implement a change in their financial reporting systems to incorporate IFRSs. Under that assumption, if the SEC determines in 2011 to incorporate IFRSs into the U.S. financial reporting system, the first time that U.S. entities would report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of Release No. 33-9109 and also can be found on the SEC's website at www.sec.gov.

.178 In August 2010, the SEC issued two releases (Release Nos. 33-9133 and 33-9134, Notice of Solicitation of Public Comment on Consideration of Incorporating IFRS Into the Financial Reporting System for U.S. Issuers) to solicit public comment on its ongoing consideration of incorporating IFRSs into the financial reporting system for U.S. issuers. The first release contains requests for comment on three topics derived from the work plan that are related to the potential impact on investors. The second release contains requests for comment on three topics, also derived from the work plan, that are related to the potential impact on U.S. issuers. All comments will be available on the SEC's website.

International Financial Reporting Standard for Small and Medium-sized Entities

.179 The IASB issued *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs*) to be a self-contained global accounting and financial reporting standard applicable to the general purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs. *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability.

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.180 The AICPA Governing Council recognizes the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01), gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs*, and a private company's expenditure of money, time and effort to convert to *IFRS for SMEs*.

.181 Information about IFRSs and *IFRS for SMEs* can be found at www.ifrs.com. Additionally, to help its membership, the AICPA has developed an IFRS for SMEs—U.S. GAAP Comparison Wiki. The purpose of the Wiki is to provide a detailed and comprehensive comparison of *IFRS for SMEs* with corresponding requirements of U.S. GAAP. But it is more than just a comparison resource—it is a wiki. That means it is a collaborative, ongoing work in progress for anyone to contribute to and use. The Wiki is found at http://wiki.ifrs.com/.

.182 Entities interested in IFRS for SMEs or possibly adopting the standard may find it helpful to take the following actions:

- *Monitor the efforts of the AICPA/FAF/NASBA "Blue-Ribbon" Panel on Standard Setting for Private Companies*. For more information about the panel, go to www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176156684820.
- *Monitor convergence efforts of FASB and the IASB*.
- *Stay informed on SEC developments*. Public companies will be directly affected by the SEC's decision to adopt IASB standards. The future of private company reporting will also likely be affected by an SEC mandate to adopt IFRSs.
- *Develop a high-level analysis of the potential impact on accounting policies, processes and systems, contracts, legal agreements, and financing and tax structures*.

Private Company Financial Reporting

.183 The AICPA and the Financial Accounting Foundation established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel also is sponsored by the National Association of State Boards of Accountancy. The "blue-ribbon panel" will provide recommendations through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies are needed. The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities taking more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries. The panel's issued report will be made available to the public, and the resulting action plan is expected to be exposed for public comment prior to that plan being finalized. The panel will issue a report containing its recommendations to the Financial Accounting Foundation (FAF) board of trustees in January 2011. The report will be publicly available, and the resulting action plan is expected to be exposed for public comment prior to the plan being finalized.

.184 During the July 2010 meeting of the panel, seven alternative models for private company financial reporting were discussed. Models based on IFRSs and a model that would have resulted in no change to private company financial reporting were eliminated. All remaining models would result in differences in GAAP for private and public entities; the main focus of the panel moving forward will be to select a model that is relevant to users of private company financial reports because this has become the overriding issue. The three primary models the panel agreed to focus on going forward are U.S. GAAP with Exclusions for Private Companies—with enhancements; U.S. GAAP—Baseline GAAP with Public Company Add-Ons; and

Separate, Stand-Alone GAAP Based on Current U.S. GAAP. Most of the panel members also expressed their discontent with the current make-up of FASB and its heavy, but appropriate, focus on public companies. This led to another key discussion topic: the structure of whatever model is chosen—the current FASB; a restructured FASB (with greater private company representation); or a new, separate Private Company Standards Board under the oversight of FAF.

Recent Pronouncements

.185 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.186 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801) Issue Date: December 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 801 to reflect changes in the compliance audit environment and incorporates the risk assessment standards. It requires the auditor to adapt and apply the AU sections of the AICPA's *Professional Standards* to compliance audits and provides guidance on how to do so. It is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.
SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, AU sec. 325) Issue Date: October 2008 (Applicable to audits conducted in accordance with GAAS)	Replacing SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, this standard defines the terms *deficiency in internal control*, *significant deficiency*, and *material weakness*; provides guidance on evaluating the severity of deficiencies in internal control identified in an audit of financial statements; and requires the auditor to communicate in writing to management and those charged with governance significant deficiencies and material weaknesses identified in an audit. It is effective for audits of financial statements for periods ending on or after December 15, 2009. Earlier implementation is permitted.
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.
Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 15, *Audit Evidence* (subject to approval by the Securities and Exchange Commission [SEC]) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard explains what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Auditing Standard No. 14, *Evaluating Audit Results* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether the auditor has obtained sufficient appropriate audit evidence. The evaluation process set forth in this standard includes, among other things, evaluation of misstatements identified during the audit; the overall presentation of the financial statements, including disclosures; and the potential for management bias in the financial statements.
PCAOB Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements for responding to the risks of material misstatement in financial statements through the general conduct of the audit and performing audit procedures regarding significant accounts and disclosures.
PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. The risk assessment process discussed in the standard includes information-gathering procedures to identify risks and an analysis of the identified risks.
PCAOB Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard sets forth requirements for supervision of the audit engagement, including, in particular, supervising the work of engagement team members. It applies to the engagement partner and to other engagement team members who assist the engagement partner with supervision.
PCAOB Auditing Standard No. 9, *Audit Planning* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding planning an audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Auditing Standard No. 8, *Audit Risk* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance that the financial statements are free of material misstatement.
PCAOB Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards) Issue Date: January 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard and its related amendments supersede the interim concurring partner review requirements and update the interim quality control standards. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB. The standard provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. It is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009.
PCAOB Staff Question and Answer, *Auditing Standard No. 7,* Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10) Issue Date: February 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This staff question and answer provides further implementation guidance on the documentation requirements of Auditing Standard No. 7 in light of comments the SEC received during its comment period.
PCAOB Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06) Issue Date: July 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert is intended to remind registered public accounting firms of their obligations when using the work of other firms or using assistants engaged from outside the firm. The alert was prompted by observations by the PCAOB that a number of registered public accounting firms located within the United States have been issuing reports on financial statements filed by issuers that have substantially all of their operations outside of the United States, and some of these firms may not be conducting those audits in accordance with PCAOB standards.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05) Issue Date: April 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert explains that significant unusual transactions, especially those close to period-end that pose difficult substance over form questions, can provide opportunities for entities to engage in fraudulent financial reporting. This staff audit practice alert is designed to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions.

Recent ASUs

.187 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2010-24. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) *Accounting Standards Codification*(ASC)	
Accounting Standards Update (ASU) No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
Liabilities Area of FASB ASC	
ASU No. 2009-15 (October 2009)	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*

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Recent Accounting Standards Updates	
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2009-13 (October 2009)	*Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
Broad Transactions Area of FASB ASC	
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2009-17 (December 2009)	*Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2009-12 (September 2009)	*Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*
ASU No. 2009-16 (December 2009)	*Transfers and Servicing (Topic 860): Accounting for Transfers of Financial assets*
Industry Area of FASB ASC	
ASU No. 2010-24 (August 2010)	*Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-23 (August 2010)	*Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*

(continued)

Recent Accounting Standards Updates	
ASU No. 2010-07 (January 2010)	*Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*

Recently Issued Technical Questions and Answers

.188 The following table presents a list of nonauthoritative accounting and audit and attest technical questions and answers recently issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Recently Issued Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
Accounting	
Technical Questions and Answers (TIS) section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"

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Recently Issued Technical Questions and Answers
(AICPA, *Technical Practice Aids*)

TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments"
TIS section 6910.33 (December 2009)	"Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination"
TIS section 2220.27 (December 2009)	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
TIS section 2220.26 (December 2009)	"Categorization of Investments for Disclosure Purposes"
TIS section 2220.25 (December 2009)	"Impact of 'Near Term' on Classification Within Fair Value Hierarchy"
TIS section 2220.24 (December 2009)	"Disclosures—Ability to Redeem Versus Actual Redemption Request"
TIS section 2220.23 (December 2009)	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
TIS section 2220.22 (December 2009)	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"
TIS section 2220.21 (December 2009)	"Determining Whether an Adjustment to NAV Is Necessary"
TIS section 2220.20 (December 2009)	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, *Financial Services—Investment Companies*"
TIS section 2220.19 (December 2009)	"Unit of Account"
TIS section 2220.18 (December 2009)	"Applicability of Practical Expedient"
TIS section 6910.32 (July 2009)	"Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt"
TIS section 6910.31 (July 2009)	"The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the '5 Percent Test' Described in TIS Section 6910.30"

(continued)

Recently Issued Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
TIS section 6910.30 (July 2009)	"Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets"
TIS section 1600.04 (June 2009)	"Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements"
TIS section 1500.07 (June 2009)	"Disclosure Concerning Subsequent Events in OCBOA Financial Statements"
Audit and Attest	
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"
TIS section 8700.02 (September 2009)	"Auditor Responsibilities for Subsequent Events"
TIS section 8700.01 (September 2009)	"Effect of FASB ASC 855 on Accounting Guidance in AU Section 560"

Recent AICPA Independence and Ethics Developments

.189 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.190 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05). Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. The PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as "maintaining internal control" for the client.

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.191 To address the possible inconsistency in Interpretation No. 101-3, the PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members better distinguish between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

.192 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

.193 Exposure drafts issued by the PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

On the Horizon

.194 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the health care industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.195 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Overhaul Project—AICPA Audit and Accounting Guide *Health Care Entities*

.196 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Health Care Entities*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1996. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.197 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the ISAs issued by the IAASB. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the first half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* and AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

.198 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on

satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Interim Financial Information

.199 In July 2010, the ASB issued two proposed SASs on interim financial information. The first, *Revised Applicability of Statement on Auditing Standards No. 116*, Interim Financial Information, is intended to revise paragraph 5 of SAS No. 116 (AICPA, *Professional Standards*, vol. 1, AU sec. 722), so that the guidance in SAS No. 116 would be applicable when the auditor audited the entity's latest annual financial statements and the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. Currently, the guidance in SAS No. 116 is applicable when the auditor performs the audit of the latest annual financial statements and expects to be engaged to audit the current year financial statements (and, therefore, is not applicable when the auditor expects that a new auditor may be engaged for the current year). This proposed amendment would be effective for interim reviews of interim financial information for periods beginning after December 15, 2011, with early implementation permitted. Comments are due by October 8, 2010.

.200 The second proposal on interim financial information, *Interim Financial Information* (Redrafted), would supersede SAS No. 116 and represents the redrafting of the guidance to apply clarity drafting conventions. The main changes to existing standards are as follows:

- Replacement of the term *accountant* with *auditor*
- The change to paragraph 5 discussed in the prior paragraph
- Requirement of the auditor to issue a written report unless the review of the interim financial information is required by a third party and the third party does not require a written review report
- Allowance of oral reports for entities that are subject to external requirements to report in a manner that is substantially similar to the reporting required of issuers, pursuant to PCAOB standards
- Requirement for the auditor to perform procedures consistent with those required for acceptance of an engagement to audit financial statements
- Requirement for the review report to include a statement that the review of interim financial information was conducted in accordance with auditing standards generally accepted in the United States of America

.201 This proposed SAS would be effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2012. Comments for this proposed SAS are also due by October 8, 2010.

Exposure Drafts on Auditor's Reports

.202 The ASB issued three proposed SASs related to auditor's reports: *Forming an Opinion and Reporting on Financial Statements*, *Modifications to the Opinion in the Independent Auditor's Report*, and *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. These proposed standards are drafted with the ASB's clarity drafting conventions and are intended to converge with ISAs. The intent of issuing three separate SASs is to assist practitioners in identifying and applying the reporting requirements and guidance. The ASB has made various changes to the related ISAs to tailor them to the United States; however these changes have not been substantial in nature.

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.203 The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Exposure Drafts on Special Considerations Audits

.204 Another exposure draft issued by the ASB contains two proposed SASs: *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks and Special Considerations—Audits of Single Financial Statements* and *Specific Elements, Accounts, or Items of a Financial Statement*. These proposed standards have been drafted with the clarity drafting conventions and are intended to converge with the equivalent ISAs. No meaningful differences exist between these proposed standards and the ISAs. *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* addresses the application of GAAS to financial statements prepared under the cash, tax, regulatory, or contractual bases of accounting. It also replaces the term other comprehensive basis of accounting with special purpose framework.

.205 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* introduces new planning, performance, and reporting requirements for these engagements. The proposed SAS also clarifies that a single financial statement and a specific element of a financial statement include the related notes.

.206 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Auditing and Attestation Pipeline—Issuers

Confirmations

.207 The PCAOB has proposed a draft of an auditing standard on confirmations. A concept release was originally issued in April 2009 and received 24 comment letters. This proposed auditing standard, issued in July 2010, would strengthen the requirements under the current auditing standard, AU section 330, *The Confirmation Process* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and replace it, upon final issuance of a standard and approval from the SEC. The proposed new standard

- requires confirmation procedures for specific accounts, such as receivables that arise from credit sales, loans, or other transactions, and also in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.
- incorporates procedures in response to the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating nonresponses to confirmation requests.
- updates the confirmation guidance to reflect significant advances in technology and explains that confirmation responses received electronically (for example, by fax e-mail, through an intermediary, or direct access) might involve additional risks relating to reliability. Therefore, the auditor must perform additional requirements.
- defines a confirmation response to include electronic or other medium.
- enhances requirements when confirmation responses include disclaimers and restrictive language by requiring the auditor to evaluate the effect on the reliability of a confirmation response. Further, if the disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

.208 In drafting this proposed standard, the PCAOB considered the guidance contained in ISA 505, *External Confirmations*, and the AICPA's proposed guidance on confirmations. This standard is anticipated to be effective for auditors for fiscal years ending on or after December 15, 2011.

Communications With Audit Committees

.209 In March 2010, the PCAOB proposed for comment an auditing standard on *Communications with Audit Committees* and a series of related amendments to its interim standards that are intended to (*a*) enhance the relevance and effectiveness of the communications between the auditor and the audit committee and (*b*) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. Two of the new requirements would be for the auditor (*a*) to establish a mutual understanding of the terms of the audit engagement with the audit committee and to document that understanding in the engagement letter and (*b*) to evaluate the adequacy of two-way communication between the auditor and audit committee. Additionally, the proposal also includes requirements for the auditor to communicate with the audit committee regarding the following:

- An overview of the audit strategy and timing of the audit, including a discussion of significant risks; the use of the internal audit function; and the roles, responsibilities, and location of firms participating in the audit
- Critical accounting policies, practices, and estimates
- The auditor's evaluation of the entity's ability to continue as a going concern

.210 The proposed standard would become effective, subject to SEC approval, for audits of fiscal years beginning after December 15, 2010.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.211 The year 2010 has been a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Balance sheet netting
- Statement of comprehensive income
- Discontinued operations

.212 A progress report for the quarter ended March 31, 2010, highlighted the following topics: (*a*) on the financial instruments and insurance contracts topics, the boards have reached different conclusions on significant technical issues that may affect the project timetables of these topics and (*b*) the boards agreed to explore an alternative approach to lessor accounting that may affect the project timetable of this topic. FASB

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and the IASB also have several other joint projects in process, including balance sheet—offsetting, emissions trading schemes, and reporting discontinued operations. In March 2010, the exposure draft *Conceptual Framework for Financial Reporting* was published for public comment. In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. Specifically, the boards were scheduled to expose for comment numerous major exposure drafts during the second quarter of 2010, and stakeholders voiced concern about their ability under those circumstances to provide high-quality input. The boards have developed a modified strategy to accommodate these concerns by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate consultation document seeking stakeholder input about effective dates and transition methods.

.213 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. The boards also decided to issue separate exposure drafts to address differences in the two sets of standards on balance sheet netting of derivative contracts and other financial instruments. The IASB has also made its projects on improved disclosures about derecognized assets and other off balance sheet risks, consolidations, and insurance contracts priorities. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, have been extended into the second half of 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively affect the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the U.S. financial system.

.214 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Comprehensive Income Exposure Draft

.215 In May 2010, FASB issued a proposed ASU on comprehensive income that would require an entity to report total comprehensive income in a continuous financial statement in two parts: net income and other comprehensive income. In that financial statement, the components of net income and the components of other comprehensive income should be displayed. The proposed ASU is intended to simplify how comprehensive income is reported by eliminating two options for how items of comprehensive income are displayed. The proposed ASU contains illustrative examples of the revised financial statement. This proposed ASU is the result of a joint project as part of IFRSs and U.S. GAAP convergence, and the IASB has separately issued a similar document. The proposed amendments would be applied on a fully retrospective basis to improve comparability between reporting periods. Further, because compliance with the proposed amendments is already permitted, early adoption would be permitted. FASB plans to align the effective date with the effective date of the amendments in the proposed ASU on financial instruments. The IASB and FASB aim to finalize an improved and converged standard on other comprehensive income in the fourth quarter of 2010.

Financial Instruments Exposure Draft

.216 Also, in May 2010, FASB issued a proposed ASU on accounting for financial instruments, derivative instruments, and hedging activities. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments, removes the threshold for recognizing credit impairments, creating a single credit impairment model for both loans and debt securities; and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.

- Changes in fair value of equity securities, certain hybrid instruments, and financial instruments that can be prepaid in such a way that the holder would not recover substantially all of its investment would be recognized in net income each reporting period regardless of an entity's business strategy for those financial instruments.
- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, a reconciliation from amortized cost to fair value would be required on the statement of position; with the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period. Therefore, net income will remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period.
- The existing probable threshold for recognizing impairments on loans would be removed. (Currently, FASB ASC 310-10-35-4 states that the concept in U.S. GAAP is that impairment of receivables [including loans] should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. Probable is defined by FASB ASC 310-10-20 as when the future event or events are likely to occur.)
- For changes in the value of financial instruments measured through other comprehensive income, an entity is required to determine if a credit impairment is appropriate at the end of each reporting period based on information related to past events and existing economic conditions. An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts the entity does not expect to collect.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected, which would better reflect a financial instrument's interest yield.
- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.
- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.217 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments). This proposed ASU was not issued jointly with the IASB and does not contain converged guidance; however, the goal still remains for both boards to issue comprehensive improvements to foster international comparability of financial information about financial instruments. The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009. The IASB also issued two exposure drafts on amortized cost and impairment and fair value option for financial liabilities in late 2009 and mid-2010, respectively; the third topic, hedge accounting, is still being deliberated by the IASB, and an exposure draft is expected in the near term. The boards have stated that they will consider together the comment letters and other feedback received on each boards' exposure drafts in an effort to reconcile their differences in ways that foster improvement and convergence.

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.218 The effective date of these amendments will be established upon issuance of the final ASU, which is expected in the second quarter of 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional 4 years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

.219 FASB has issued frequently asked questions for the proposed ASU to clarify the proposal by answering common questions received about the proposed guidance. This document can be accessed at www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157295447.

Revenue Recognition Exposure Draft

.220 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from Contracts with Customers*, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.221 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities (for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (performance obligation is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).
- determine the transaction price (transaction price is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.222 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*)

recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

.223 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the boards plan to invite additional comment through a separate consultation on how best to transition over to the new standards. Therefore, no expected specific effective date is stated at this point. Comments on the exposure draft are due on October 22, 2010. This topic is considered by many to be the most pervasive of any FASB has ever worked on. The reader is encouraged to review the exposure draft, consider if it is operational to you or your clients' common revenue transactions, and share any resulting concerns with FASB. The boards also anticipate holding public roundtable meetings after the end of the comment period.

Fair Value Exposure Draft

.224 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.225 The first two of these significant amendments are intended to clarify the application of existing fair value measurement guidance. The last three of these significant amendments would change a particular principle of fair value guidance.

.226 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines *highest and best use* as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values do not depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.227 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

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.228 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to interest rate risk, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice. However, they might affect the current practice for reporting entities that apply the in-use valuation premise more broadly.

.229 The proposed amendments regarding the application of blockage factors and other premiums and discounts in fair value measurements would make two changes to current guidance. Currently, under U.S. GAAP, use of a blockage factor in fair value measurements is only prohibited when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). This would be level 1 within the fair value hierarchy. The first change from the proposed amendments is that a blockage factor is not relevant and, therefore, also should not be used when fair value is measured using a valuation technique that does not use a quoted price. This would be level 2 or level 3 within the fair value hierarchy. Second, the amendments specify that fair value measurements categorized within level 2 and level 3 take into account other premiums and discounts when market participants would consider those premiums or discounts when pricing an asset or a liability, consistent with the unit of account for that asset or liability. Examples include a control premium or a noncontrolling interest discount. These proposed amendments may affect current practice for any reporting entities applying a blockage factor in fair value measurements that is measured using quoted prices and categorized within level 2 of the fair value hierarchy.

.230 Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

- The effect on a fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances
- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use
- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

.231 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. A final ASU is expected to be issued in the first quarter of 2011.

Financial Statement Presentation Staff Draft

.232 FASB and the IASB are working together to establish a common standard that would improve how information is organized and presented in financial statements. This common standard is intended to address users' concerns that existing requirements permit too many alternative types of presentation and that

information in financial statements is highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between an entity's financial statements and its financial results. In 2008, a discussion paper was issued by the boards that outlined the proposed principles for presenting financial statements in a way that portrays a cohesive financial picture of an entity.

.233 Given the magnitude of this project, the expected implementation costs, and the substantial effects it will have on financial statement presentation for many years to come, the boards decided in May 2010 to modify the strategy for this project. Before finalizing an exposure draft, the boards decided to engage in additional outreach activities that focus on the perceived benefits and costs of the proposals and the implications of the proposals for financial reporting by financial service entities. The boards plan on discussing these two areas of focus with preparers and users of financial statements. This outreach will be based on a rough draft of a proposed standard, known as a *staff draft*, and reflects the cumulative tentative decisions made by the boards, concluding with their joint meeting in April 2010. This staff draft was made publicly available solely for this purpose.

.234 The proposals in this project would be applicable to all entities, except a benefit plan within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*; FASB ASC 962, *Plan Accounting—Defined Contribution Pension Plans*; and FASB ASC 965, *Plan Accounting—Health and Welfare Benefit Plans*, or IAS 26, *Accounting and Reporting by Retirement Benefit Plans*. The two core financial statement principles in this proposal are cohesiveness and disaggregation. A common structure for the statements of financial position, comprehensive income, and cash flows would be established in the form of required sections, categories or subcategory, and related subtotals. Some proposed specific changes in the classification and format of financial statements include the following:

- Related information would be displayed in the same sections, categories, and subcategory in each statement so that information is more easily associated.
- Presentation of business and financing activities would be separated as follows:
    - The business section would include items that are part of an entity's daily operations and other income generating activities.
    - The financing section would include items that are part of an entity's activities to obtain (or repay) capital.
- Discontinued operations and income taxes would be presented in their own separate sections.
- The statement of changes in equity would not include the sections and categories used in the other statements because that statement presents information solely about changes in items classified in the equity category in the statement of financial position.

.235 Further, FASB plans to propose some changes that are already required by IAS 1, *Presentation of Financial Statements*. The proposal would define and provide the requirements for a complete set of financial statements. Currently, a complete set of financial statements for the period is defined only in the FASB Concepts Statements. An entity would also be required to present one period of comparative information. A complete set of financial statements would consist of, at a minimum, statements of financial position, comprehensive income, cash flows and changes in equity, and notes to financial statements for two periods (the current period and the previous period). Also, an opening statement of financial position would be part of a complete set of financial statements if an entity applies an accounting principle retrospectively, restates its financial statements, or reclassifies items in the financial statements.

.236 The boards' tentative decisions on financial statement presentations do differ in a few ways in relation to minimum line requirements for the statement of financial position, segment reporting, and net debt presentation. Of these three, the differing stance on segment reporting is the only significant difference. The boards now aim to issue an exposure draft in the first quarter of 2011 and a final improved and converged standard in the fourth quarter of 2011. Both the introduction to the staff draft and the staff draft can be accessed from FASB's website at www.fasb.org.

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Leases Exposure Draft

.237 During the third quarter of 2010, the IASB and FASB published for public comment joint proposals to improve the financial reporting of lease contracts. These proposals would result in a consistent approach to lease accounting for both lessees and lessors—a "right of use" approach. This would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, therefore providing more complete and useful information to investors and other users of financial statements. Currently, the accounting for a lease depends on its classification; an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRSs or U.S. GAAP, whereas a capital lease results in the lessee recognizing an asset and an obligation. Under the proposed guidance, lessees would only have one method of accounting for leases, which would produce more complete and comparable financial reporting in addition to reducing the opportunity to structure transactions to achieve a desired accounting outcome.

.238 The scope of the new lease guidance includes all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. Under this new guidance, all lessees would use a single method of accounting for all leases: an asset would be recognized representing the lessee's right to use the leased (underlying) asset for the lease term (the right-of-use asset), and a liability at the present value of the expected lease payments would also be recognized.

.239 A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either (*a*) recognize a lease liability while continuing to recognize the underlying asset (a *performance obligation approach*); or (*b*) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a *derecognition approach*). The assets and liabilities recognized by both lessors and lessees would be measured on the basis that

- assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- a remeasurement is triggered when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

.240 For leases of 12 months or less, lessors and lessees would be able to apply simplified requirements. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. New disclosures would also be required.

.241 In early 2009, the boards issued a discussion paper on leases; this exposure draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors, regulators, and other interested parties since that discussion paper. The comment period is open until December 15, 2010. During the comment period, the boards will undertake further outreach activities, including public round-table meetings to ensure that the views of all interested parties are taken into consideration before the new standard is completed. Also, the boards will share and jointly consider all comment letters received. A final standard is expected in the second quarter of 2011. The AICPA has developed questions and answers to highlight the important aspects of the proposals, which can be located at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/DownloadableDocuments/EDITED_LEASES_FAQ.pdf.

Insurance Contracts Discussion Paper

.242 In June 2010, the IASB issued an exposure draft of a proposed IFRS that would apply to all insurance contracts written by both insurance entities and noninsurance entities. Three months later, FASB issued a

discussion paper to solicit broad-based input on how to improve, simplify, and converge the financial reporting requirements for insurance contracts. The solicited feedback is focused on (*a*) whether the IASB's proposal would be a sufficient improvement to U.S. GAAP to justify the cost of change; (*b*) whether the project goals of improvement, convergence, and simplification would be more effectively achieved by making targeted improvements to existing U.S. GAAP (rather than issuing comprehensive new guidance); and (*c*) certain critical accounting issues for which the preliminary views of FASB differ from the IASB's exposure draft. It is important to remember that although the project on insurance contracts is a joint project, it is not part of the boards' MoU.

.243 The discussion paper summarizes the key aspects of the IASB's exposure draft and compares the proposed changes with both the alternative preliminary views of FASB and the current guidance in FASB ASC 944, *Financial Services—Insurance*. FASB decided to issue a discussion paper rather than an exposure draft because of the following reasons:

- The extent of FASB's and the IASB's current accounting guidance for insurance contracts varies significantly; U.S. GAAP comprehensively addresses accounting for insurance contracts by insurance entities, whereas IFRSs do not have comprehensive guidance. Further, the boards have not explicitly evaluated whether the model proposed in the IASB's exposure draft would represent an improvement to U.S. GAAP.
- FASB has not determined whether one model or two models would result in more useful information about insurance contracts. FASB would like additional input from stakeholders on whether different types of insurance contracts warrant different recognition, measurement, and presentation and, if so, what criteria should be used for determining which, if any, types of insurance contracts would use each model.
- FASB is considering whether employer-provided health insurance should be included within the scope of the insurance contracts project and how recent U.S. health care reform may affect the application of the different approaches.

.244 The discussion paper also includes a listing of common elements of U.S. GAAP on insurance contracts that some stakeholders note could be improved. The appendix of the discussion paper compares the main areas of current U.S. GAAP for insurance contracts, the IASB's proposed approach, and FASB's preliminary views that differ from the proposed approach included in the IASB's exposure draft. Comments are due by mid-December 2010. Additionally, FASB and the IASB plan to host a series of public roundtable meetings in December 2010 to hear stakeholders' views. Readers should be alert for developments on this topic.

Auditing Considerations of Accounting Convergence

.245 Although the future of convergence between IASB and FASB accounting standards remains an unknown, discussions have already begun about the potential impact on auditors. Although auditors are accustomed to new standards, the nature and volume of these changes will likely pose new challenges. Among others, some of these potential challenges include the following:

- Training audit staff on a large amount of new accounting guidance that is based on an accounting approach (that is, principles based versus rules based)
- Developing, as necessary, any new internal audit guidance, such as firm methodology
- Implementing any new resulting auditing rules
- Creating a new framework for documenting audit conclusions on a principles-based accounting approach
- Audit committees learning new accounting guidance to effectively perform their function

.246 In addition to the challenges auditors will face, the effects on preparers will also be great. At the time of this writing, it appears that the transition timeline to convergence will be relatively short; this will divert resources during the preparation of financial statements as entities focus on implementing the new principles,

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which may result in increased audit risk. Auditors, in addition to preparers, are also encouraged to remain current on developments of international accounting convergence.

FASB Accounting Pipeline

Health Care Entities: Revenue Recognition Exposure Draft

.247 FASB has a project on revenue recognition for health care entities. The issue is whether collectability must be reasonably assured prior to a health care entity recognizing revenue. Health care entities may perform services for which the ultimate collection of all or a certain portion of the amount billed or billable is not expected in its entirety, is doubtful, or cannot be determined at the time the services are rendered. In some situations (for example, charity care), health care entities record no revenue. For billings to self-pay patients, it has been industry practice for health care entities to adopt a revenue recognition policy to record revenue at the gross charge along with a relatively high bad debt provision, as provided for in FASB ASC 904-605-25-3. Health care entities that apply this policy also record revenue for insured patients when services are provided and adjust that revenue for contractual allowances (discounts) based on third-party payor or other arrangements. A bad debt provision is typically recorded for the amount due for deductibles and copays judged to be uncollectible. The bad debt provision is generally classified as an expense and not as a reduction to revenue.

.248 The effective date for the proposed amendments would be determined after the exposure period. Readers should be alert to the development of this topic.

Fees Paid to the Federal Government by Pharmaceutical Manufacturers *Exposure Draft*

.249 In August 2010, FASB issued a proposed ASU on accounting for certain fees associated with recently enacted health care legislation. The issues are (*a*) how the annual fee imposed by the PPACA and the Health Care and Education Reconciliation Act of 2010 (HCERA) should be classified in a reporting entity's income statement and (*b*) whether the annual fee should be expensed in its entirety when the liability is recognized or whether an asset should be recognized and amortized over the calendar year.

.250 The HCERA contains a number of provisions that will affect the accounting for many entities. This issue addresses one aspect of accounting for the fees payable by pharmaceutical manufacturers to the federal government. The HCERA imposes an annual fee on the pharmaceutical manufacturing sector for each calendar year beginning after 2010. The fee ranges from $2.5 billion to $4.1 billion and is payable by no later than September 30 of the applicable calendar year. This is a nondeductible fee that will be allocated across the industry based on relative market share. The annual fee payable in a given calendar year is determined by reference to sales in the preceding calendar year. This issue applies to all pharmaceutical manufacturers that are subject to this fee, which according to Section 9008 of the HCERA is any manufacturer or importer with gross receipts from branded prescription drug sales to any federal government program. Practice is likely to recognize the fee in earnings on a ratable basis in the calendar year in which the fee is paid. The rationale is that a pharmaceutical company does not have a liability, as defined by FASB Concepts Statement No. 6, *Elements of Financial Statements—a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)*, prior to the year sales are made that trigger the payment.

.251 Although there does not appear to be diversity in the timing of when the fees will be recognized, divergent views do exist about how such fees should be classified in the income statement. Some constituents believe that the fees should be classified as a reduction of revenue, but others believe they should be accounted for as an operating cost.

.252 The amendments in the proposed ASU specify that upon recognition of the liability, the annual fee would be (*a*) recognized over the calendar year that it is payable using a straight-line method of allocation, unless another method better allocates the fee over the calendar year it is payable, and (*b*) presented as operating expenses.

.253 The amendments in the proposed ASU would be effective for calendar years beginning after December 31, 2010, when the fee initially becomes effective. Readers should be alert to the final issuance of this ASU.

Accounting for Legal Costs Associated with Medical Malpractice Claims *Exposure Draft*

.254 In August 2010, FASB issued a proposed ASU on accounting for legal costs associated with medical malpractice claims. The main issue of this proposal is whether the industry-specific requirement that health care entities accrue legal costs related to litigating medical malpractice claims or similar claims before those costs are incurred should be eliminated.

.255 In other industries, entities make an accounting policy election to either expense legal fees as incurred or accrue estimated legal fees when the associated claim is incurred (FASB ASC 450-20-S99-2). Some believe that guidance would benefit from eliminating an industry-specific exception for health care entities and aligning the accounting practices in that industry with FASB ASC 450-20.

.256 The objective of the proposed ASU is to eliminate the industry-specific requirement that health care entities accrue legal costs related to litigating medical malpractice claims or similar claims before these costs are incurred.

.257 The amendment would affect health care entities within the scope of FASB ASC 954, *Health Care Entities*. The amendment would allow health care entities to make a policy election to expense legal fees as incurred or accrue estimated legal fees when the associated claim is incurred. The effective dates of this proposed amendment would be determined after the feedback from the draft is considered. However, the amendments would be applied retrospectively to all prior periods presented. Readers should be alert to the final issuance of this ASU.

Disclosure of Certain Loss Contingencies

.258 In July 2010, FASB issued an exposure draft on the disclosure of certain loss contingencies in response to concerns from investors and other financial statement users that the current disclosures do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. The objective of these disclosures would be for an entity to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following: the nature of the loss contingencies, their potential magnitude, and their potential timing (if known). Disclosure of certain remote loss contingencies would be required and, therefore, would expand the population of loss contingencies that are required to be disclosed. An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required. Further, current qualitative disclosures would be enhanced by requiring additional disclosures. These additional required qualitative and quantitative disclosures include the following:

- For litigation contingencies, the contentions of the parties and how users can obtain more information about the litigation
- Publicly available quantitative information, such as the claim amount for asserted litigation contingencies; other relevant nonprivileged information; and, in some cases, information about possible recoveries from insurance and other sources
- For public entities, tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the period

.259 The amendments in this proposal would affect all entities. The exposure draft noted that FASB will continue to work with the PCAOB, the AICPA, and the American Bar Association (ABA) to identify and address any potential implications of the proposed amendments for auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The proposed amendments would be effective for fiscal years ending after December 15, 2010, for public entities and in the

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first annual period beginning after December 15, 2010, for nonpublic entities. The comment period ended in September 2010.

Going Concern FASB Project

.260 Currently, the only guidance on going concern resides in the auditing literature, and this project's intention is to incorporate going concern guidance into U.S. GAAP. Specifically, this guidance would discuss the following:

- Preparation of financial statements as a going concern
- An entity's responsibility to evaluate its ability to continue as a going concern
- Disclosure requirements when financial statements are not prepared on a going concern basis
- Disclosure requirements when there is a substantial doubt about an entity's ability to continue as a going concern
- The adoption and application of the liquidation basis of accounting

.261 A revised exposure draft is expected to be issued in the second quarter of 2010, with a final ASU expected in the third quarter of 2010. FASB has decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Readers should be alert to developments on this topic.

Other Accounting Projects

.262 Additionally, FASB has the following projects underway:

- Troubled debt restructuring
- Disclosure framework
- Investment properties

Resource Central

.263 The following are various resources that practitioners engaged in the health care industry may find beneficial.

Publications

.264 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *Health Care Entities* (2010) (product no. 0126110 [paperback] or WHC-XX [online with the associated Audit Risk Alert])
- Audit and Accounting Guide *Not-for-Profit Entities* (2010) (product no. 0126410 [paperback], WNP-XX [online with the associated Audit Risk Alert])
- Audit Guide Government Auditing Standards *and Circular A-133 Audits* (2010) (product no. 0127410 [paperback], WRF-XX [online with associated Audit Risk Alert])
- Audit and Accounting Guide *State and Local Governments* (2010) (product no. 0126610 [paperback]. WGG-XX [online with the associated Audit Risk Alert])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])

- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Guide *Compilation and Review Engagements* (2010) (product no. 0128110 [paperback] or WRC-XX [online])
- Audit Guide *Auditing Revenue in Certain Industries* (2010) (product no. 0125110 [paperback] or WAR-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Compilation and Review Alert *Compilation and Review Developments—2010/11* (product no. 0223010 [paperback])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- Checklists and Illustrative Financial Statements *Health Care Entities* (product no. 0090210 [paperback] or WHE-CL [online])
- *Accounting Trends & Techniques, 62nd Edition* (product no. 0099009 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099109 [paperback] or WIF-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])

AICPA Online Professional Library: Accounting and Auditing Literature

.265 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB* Accounting Standards Codification™, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]).To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.266 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop (2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Strong Foundation* (product no. 741602 [text], 181601 [DVD/Manual], or 351601 [Additional Manual for DVD]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

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.267 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.268 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the health care industry include the following:

- *Nonprofit Auditing: Unique Auditing for a Unique Entity*
- *Fraud in Exempt Organizations: The Governmental and Not-for-Profit Environments*
- *Nonprofit Accounting: Financial Reporting*
- *Auditing Considerations in an Uncertain Economy*

.269 To register or learn more, visit www.cpa2biz.com.

Webcasts

.270 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.271 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.272 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.273 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conference

.274 The AICPA offers an annual health care industry conference in the fall. The health care industry conference is a two-day conference designed to update attendees on recent developments related to the health

care industry. The AICPA National Health Care Industry Conference will be held on Nov 11–12, 2010, in Las Vegas, NV. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Governmental Audit Quality Center

.275 The Governmental Audit Quality Center (GAQC) is firm-based, voluntary membership center designed to improve the quality and value of governmental audits provided to purchasers of governmental audit services. Governmental audits are performed under *Government Auditing Standards* and are audits and attestation engagements of federal, state, or local governments; NFP organizations; and certain for-profit organizations, such as housing projects and colleges and universities that participate in governmental programs or receive governmental financial assistance. The GAQC keeps member firms informed about the latest developments and provides them with tools and information to help them better manage their audit practice. Firms and that join demonstrate their commitment to audit quality by agreeing to adhere to certain membership requirements.

.276 The GAQC has been in existence since September 2004. Since its launch, center membership has grown to almost 1400 firms from 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The membership accounts for approximately 84 percent of the total federal expenditures covered in single audits performed by CPA firms in the Federal Audit Clearinghouse database (http://harvester.census.gov/sac/) for the year 2009.

.277 The GAQC's focus is to promote the highest quality audits and to save firms time by providing a centralized place to find information that they need, when they need it, to maximize quality and practice success. Center resources include the following:

- E-mail alerts with the latest audit and regulatory developments, including information on the Recovery Act and its impact on your audits
- Exclusive web seminars, webcasts, and teleconferences on compliance auditing and timely topics relevant to governmental and NFP financial statement audits (optional CPE is available for a small fee, and events are archived online)
- Dedicated GAQC website at www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx with resources (including a Recovery Act Resource Center), community events, and products, and a complete listing of GAQC members in each state
- Online member discussion forums for sharing best practices and discussing issues firms are facing
- Savings on professional liability insurance

.278 For more information about the GAQC, visit www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx.

The Center for Audit Quality

.279 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.280 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit www.aicpa.org/InterestAreas/CenterForAuditQuality/Pages/CAQ.aspx.

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AICPA Industry Expert Panel—Health Care

.281 For information about the activities of the AICPA Health Care Expert Panel, visit the panel's website at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/HEALTHCARE/Pages/Healthcare.aspx.

Industry Websites

.282 The Internet covers a vast amount of information that may be valuable to auditors of health care entities, including current industry trends and developments. Some of the more relevant sites for auditors with health care industry clients include those shown in the following table:

Organization	*Website*
Centers for Medicare & Medicaid Services	www.cms.hhs.gov
U.S. Department of Health & Human Services	www.hhs.gov
Global health reporting	http://globalhealth.kff.org/
Kaiser Family Foundation	www.kff.org
Atlantic Information Services	www.aishealth.com

.283 The health care practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

.284

Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org

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Website Name	*Content*	*Website*
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov

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AAM Section 8040

Insurance Industry Developments—2010/11

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Insurance Industry Developments—2010*.

This Audit Risk Alert is intended to provide auditors of financial statements of the insurance industry with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

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Feedback

The Audit Risk Alert *Insurance Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your insurance audits and also can be used by an entity's internal management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) explains important issues that affect all entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

The Current Economy

.03 When planning and performing audit engagements, an auditor should understand both the general current economy and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

.04 The year 2010 may be the beginning of a wave of economic recovery. Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. Further, after experiencing a considerable decline in the stock market through March 2009, the markets have rebounded substantially. In March 2009, the S&P 500 and the Dow Jones Industrial Average reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002. By March 2010, only a year later, all 3 had increased in value by at least 59 percent from the previous year's lows. However, all 3 remained relatively unmoved 5 months later, in late September 2010. This exhibits the continuing uncertainty in the markets due to the varying economic indicators, the financial reform regulatory changes, and Europe's economy, among other reasons.

Key Economic Indicators

.05 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.06 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.6 percent in the second quarter of 2010 (second estimate), 3.7 percent in the first quarter of 2010, and 5.6 percent in the fourth quarter of 2009. This data indicates a turnaround in the economy because in the fourth quarter of 2008 and the first quarter of 2009, real GDP decreased 6.3 percent and 5.5 percent, respectively. Further, in June 2010, the Treasury reported that

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banks had repaid about 75 percent of the bailout money they received through the Troubled Asset Relief Program, and that taxpayers made $21 billion on the investment. However, other significant or large bailouts are not yet repaid, and they may yield losses to taxpayers.

.07 From August 2009 to August 2010, the unemployment rate fluctuated between 9.5 percent and 10.1 percent. An unemployment rate of 10.0 percent represents approximately 15.3 million people. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. However, through August 2010, the rate has remained below 10.0 percent. Additionally, 1 reason for the continued high unemployment rate is that more Americans are resuming their search for work.

.08 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent, where it remained through September 2010. The Federal Reserve described the current economic recovery in its September 21, 2010, press release as follows:

- Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software is rising, though less rapidly than earlier in the year, and investment in nonresidential structures continues to be weak.
- Employers remain reluctant to add to payrolls.
- Housing starts are at a depressed level.
- Bank lending has continued to contract, but at a reduced rate in recent months.
- The pace of economic recovery is likely to be modest in the near term.

.09 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant its holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the beginning of the financial market turmoil in August 2007, the Federal Reserve's balance sheet has grown from $869 billion to $2.3 trillion. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

Industry Trends and Conditions

Life and Health Insurance Industry

Impact of the Financial Crisis on the Life Insurance Industry

.10 Throughout 2008 and 2009, the life insurance industry was affected adversely by the global economic downturn and turbulent financial markets. Most life insurance entities experienced net losses in 2008 and 2009. According to A.M. Best's August 10, 2010, special report, *Slow Economic Recovery Promotes Volatility in Capital Markets,* since that time, the industry has seen more favorable trends. Unrealized loss positions in investment portfolios have largely recovered as of first quarter 2010; however, sizable blocks of in-force variable annuities remain exposed to equity market downside, and the outlook for residential and commercial mortgage investments remains uncertain. A.M. Best has upgraded its rating outlook on the U.S. life and annuity sector from negative to stable. Several life insurers have successfully raised capital through debt and equity issuances. Even with the considerable upsurge in the industry's capitalization on both an absolute and risk adjusted basis, A.M. Best believes that the overall quality of capital has diminished given the volume of recent surplus note issuances, reserve financings, and reinsurance transactions to provide capital relief.

.11 According to the National Association of Insurance Commissioners' (NAIC's) report, *Life Insurer Solvency*, despite the recessionary effects experienced by the life insurance industry, insurance regulators maintain that the majority of life insurance entities are capitalized adequately, and the industry is positioned

for success. Also, A.M. Best's August 10, 2010, special report, *Slow Economic Recovery Promotes Volatility in Capital Markets*, predicts favorable long-term trends for the industry as a result of the following factors:

- Life insurance entities generally invest for the long-term.
- Credit spreads have narrowed significantly, indicating possible recovery of the financial markets.
- Portfolio investment yields have remained reasonably steady.
- Access to the capital markets has normalized.
- Equity markets have rallied recently and credit markets have opened.

.12 In addition, companies in the life insurance industry have made progress in de-risking their balance sheets, de-emphasizing sales of products that are more capital intensive, redesigning and repricing products, tightening their focus on core business lines and exiting segments in which competition is intense, required margins cannot be met, or a combination of these.

.13 Life insurance companies were some of the largest purchasers of subprime and prime mortgages issued during the years 2004 through 2007. In August 2010, the NAIC's Valuation of Securities Task Force announced a slight improvement in the performance of certain residential mortgage-backed securities (RMBS). It is important to note that the high unemployment rate plaguing the U.S labor force may still have a dramatic impact on many of the outstanding RMBS.

.14 In September 2010, the NAIC announced that Blackrock Solutions has been engaged to develop expected losses for more than 7,000 commercial mortgage-backed securities (CMBS), allowing insurance companies to map their CMBS holdings to the appropriate risk-based capital (RBC) designation.

Outlook for Health Insurance Entities

.15 Health insurance entities face significant challenges commencing in 2010 as a result of the passage of the Patient Protection and Affordable Care Act (PPACA). The industry remains highly competitive, and the opportunity for growth is limited. According to A.M. Best's February 8, 2010, special report, *Weak Economy, Higher Costs, Enrollment Declines Hurt Results*, rising unemployment led to a 2.3 percent reduction in commercial membership. Despite stronger stock and bond markets, investment income has continued to face pressure from low interest rates.

.16 As discussed in A.M. Best's May 24, 2010, briefing, *Health Care Reform's Near-Term Effects on Insurers*, the recession and health care reform likely will significantly affect health insurance entities. A.M. Best maintains a negative outlook on the U.S. health insurance segment. Large insurers typically have the scale and ability to adapt to health care reform, including new minimum loss ratio requirements, but will be adversely affected by the economic downturn. Smaller and more specialized insurers, with loss ratios below the minimum and higher expense ratios, may lack the scale to lower expense ratios to offset the required increase in loss ratio. Employers and individuals are expected to request lower premiums and negotiate lower rate increases. Layoffs, company closures, and smaller employers dropping insurance coverage likely will lead to enrollment declines. In addition, individuals who are unemployed are not likely to enroll in individual policies as a result of the high cost.

Property and Casualty Insurance Industry

.17 The two top trends for the property and casualty industry in 2010 are the presence of a strong bottom line recovery driven by improved investment conditions and the release of prior year reserves, both of which are sharply contrasted by a shrinking top line due to the continued impact of a sluggish economy.

.18 Fundamentally, the property and casualty industry remains strong and resilient. As per A.M. Best's special report, discussed previously, the U.S. property and casualty industry benefited from the continued recovery in the financial markets to post a net profit after-tax of $11.5 billion for the first quarter of 2010, rebounding from a net loss of $0.9 billion in the corresponding 3 months of 2009. The improvement was driven

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largely by the $2.9 billion in realized capital gains in the first quarter of 2010 (first quarter of 2009—$7.9 billion realized loss). In addition, the property and casualty industry earned an annualized statutory rate of return on average surplus of 6.7 percent in the first quarter of 2010 (first quarter of 2009—negative 1.2 percent) and an improved combined ratio of 101.0 for the industry for the 3 months ended March 31, 2010 (3 months ended March 31, 2009—combined ratio 102.2).

.19 However, the latest data from the property and casualty industry shows flat to down pricing in most lines of insurance. Even before the current recession, net written premiums in the U.S. property and casualty insurance industry declined in 2007, 2008, and 2009, and with a 1.3 percent decline in net written premiums in the first quarter of 2010, they have now started their fourth consecutive year of decline—a disturbing trend last seen during the Great Depression from 1930 to 1933.

.20 Based on the first two quarters of 2010, the industry's key drivers for the remainder of 2010 appear to be continuing soft market conditions, sluggish economic recovery, and an elevated level of catastrophic activity.

Continuing Soft Market Conditions

.21 "The soft market is still going strong," David K. Bradford, Advisen executive vice president, said in a statement. By mid-2010, the 2 largest market segments—commercial property and general liability—had market decreases of 4 percent.

.22 Insurance capacity remains abundant in almost every line and, as a result of the recession, demand for that capacity has fallen. However, given the ominous 2010 hurricane season forecast, if catastrophe losses soak up enough capacity, prices could increase for all lines.

Weather and Catastrophes

.23 According to A.M. Best's special report, *U.S. Property/Casualty—3-Month Review*, insured catastrophe losses reached $4.3 billion in the first 3 months of 2010, up from $3.0 billion reported during the same period in 2009. Munich Re Group reported in July that natural disasters cost insurance entities $22 billion in the first half of 2010. Economic losses were estimated to be $70 billion worldwide, well above the first half average over the past 10 years. The 2 catastrophes with the largest loss of life were earthquakes in Haiti and China. The largest catastrophe in terms of property damage was an earthquake in Chile, which accounted for nearly 40 percent of the first half totals. The losses related to the Deepwater Horizon oil rig incident are estimated to be about $5 billion. The National Oceanic and Atmospheric Administration has forecasted the 2010 hurricane season to be active, with a 70 percent chance of having between 14 and 20 named storms, including 3 named storms through August 2010.

Legislative and Regulatory Developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.24 On July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law. The Dodd-Frank Act was approved by the House on June 30, before narrowly clearing the Senate on July 15. The Dodd-Frank Act will create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisers. Some of the highlights of the Dodd-Frank Act are summarized in the following paragraphs.

Financial Stability Oversight Council

.25 The Dodd-Frank Act creates a new systemic risk regulator called the Financial Stability Oversight Council (FSOC). The FSOC will identify any company, product, or activity that could threaten the financial

system. It will be chaired by the Treasury secretary, and members will be heads of regulatory agencies, including the chairmen of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC), among others. For those large entities deemed a threat to the U.S. financial system, the FSOC can, under the authority of a new orderly liquidation authority, authorize the FDIC to close such entities under the supervision of the Federal Reserve. The FSOC, through the Federal Reserve, will also have the power to break up large firms; require increased reserves; or veto rules created by another new regulator, the Bureau of Consumer Financial Protection (BCFP), with a two-thirds vote. The first meeting of the FSOC will be in October 2010.

Bureau of Consumer Financial Protection

.26 The new BCFP consolidates most federal regulation of financial services offered to consumers. The director of the BCFP replaces the director of the Office of Thrift Supervision (OTS) on the FDIC board. Almost all credit providers, including mortgage lenders, providers of payday loans, refund anticipation loan providers, other nonbank financial companies, and banks and credit unions with assets over $10 billion, will be subject to the new regulations. Functions currently handled by existing agencies are expected to be transferred to the BCFP, and the BCFP is expected to assume full authority for consumer financial protection no later than 1 year after enactment.

.27 The Dodd-Frank Act recognizes that CPAs providing customary and usual accounting activities (which include accounting, tax, advisory, or other services that are subject to the regulatory authority of a state board of accountancy) and other services incidental to such customary and usual accounting activities are already adequately regulated and, therefore, are not subject to the BCFP's authority.

Sarbanes-Oxley Section 404(b) Exemption

.28 The Dodd-Frank Act amends SOX to make permanent the exemption from its Section 404(b) requirement for nonaccelerated filers (those with less than $75 million in market capitalization) that had temporarily been in effect by order of the SEC. Section 404(b) of SOX requires companies to obtain an auditor's report on management's assessment of the effectiveness of the company's internal control over financial reporting. In September 2010, the SEC issued Final Rule Release Nos. 33-9142; 34-62914, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, to conform its rules to this resulting change from the Dodd-Frank Act.

.29 The Dodd-Frank Act also requires the SEC to complete a study within 9 months of the act's enactment on how to reduce the burden of Section 404(b) SOX compliance for companies with market capitalizations between $75 million and $250 million. The study will consider whether any such methods of reducing the burden, or a complete exemption, would encourage companies to list on U.S. exchanges.

Auditors of Broker-Dealers

.30 The Dodd-Frank Act also provides for the PCAOB to create a program for registering and inspecting the auditors of broker-dealers, including standard setting and enforcement. Currently, all auditors of broker-dealers must be registered with the PCAOB. Covered auditors will now be required to follow PCAOB guidance. The Dodd-Frank Act allows the PCAOB, in its inspection rule, to differentiate among broker-dealer classes and to potentially exempt introducing brokers, such as those who do not engage in clearing, carrying, or custody of client assets.

Derivatives Trading

.31 The Dodd-Frank Act requires standardized swaps to be traded on an exchange, or in other centralized trading facilities, to better promote transparency in this complex market. Standardized derivatives will also have to be handled by central clearinghouses. However, a measure requiring banks to spin off their swaps trading units was scaled back in the final version of the Dodd-Frank Act. Banks will still be able to trade swaps to hedge risk and trade interest rate or foreign exchange swaps, but dealing in riskier swaps transactions must

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still be moved into affiliates. Clearing and exchange trading requirements are expected to become effective 360 days following enactment.

Accounting Standards

.32 The Dodd-Frank Act gives the FSOC the duty to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress to make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets. The FSOC may submit comments to the SEC and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure.

Registered Investment Advisers

.33 Currently, the Investment Advisers Act of 1940 requires investment advisers with over $30 million in assets under management to register with the SEC. Under the Dodd-Frank Act, this threshold for federal regulation will be raised to $100 million, with certain exceptions. This change will increase the number of advisers under state supervision.

Aiding and Abetting Securities Fraud

.34 Because it lowers the legal standard from "knowing" to "knowing or reckless," the Dodd-Frank Act may make it easier for the SEC to prosecute aiders and abettors of those who commit securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. Additionally, the Dodd-Frank Act authorizes 2 studies on these matters. One of the studies directs the Government Accountability Office (GAO) to investigate the impact of authorizing private rights of action for aiding and abetting claims and to release its findings within 1 year. The second study directs the SEC to examine whether private rights of action should be authorized for transnational or extraterritorial claims, and that study is to be completed within 18 months.

Advisers to Private Funds

.35 The Dodd-Frank Act eliminates the private adviser exemption under the Investment Advisers Act of 1940, which will consequently result in more advisers having to register with the SEC. Advisers to venture capital funds remain exempt from registration, as well as advisers to private funds if such an adviser acts solely as an adviser to private funds and has U.S. assets under management below $150 million. The Dodd-Frank Act also amends the Investment Advisers Act of 1940 to specifically exclude family offices from registration as an investment adviser. The new registration requirement will become effective 1 year after enactment; however, any investment adviser may, at the discretion of the investment adviser, register with the SEC during that 1-year period.

Executive Compensation

.36 The Dodd-Frank Act requires a nonbinding shareholder vote on executive pay. At a public company's first shareholder meeting following the end of the six month period after enactment, management must give shareholders the opportunity to vote on how frequently shareholders will have a "say on pay" (that is, annually, every two years, or every three years). Compensation based on financial statements that are restated must be returned for the three years preceding the restatement in an amount equal to the excess of what would have been paid under the restated results. Listing exchanges will enforce the compensation policies. The Dodd-Frank Act also requires directors of compensation committees to be independent of the company and its management and requires new disclosures regarding compensation.

Other Requirements and Additional Information

.37 The Dodd-Frank Act requires the SEC, within 80 days after enactment, to issue rules requiring companies to disclose in their proxy statement why they have separated, or combined, the positions of chairman and CEO. The OTS, which is currently the regulator for savings-and-loan financial institutions, will be abolished under the Dodd-Frank Act. Under the Dodd-Frank Act, such institutions will now be regulated by the Office of the Comptroller of the Currency, which also regulates federally chartered banks. A copy of the full Dodd-Frank Act, as signed by the president, can be found at www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/BILLS-111hr4173ENR.pdf. The AICPA is also following any developments related to the Dodd-Frank Act on our website at www.aicpa.org under "Advocacy—Federal Issues."

The Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act

.38 In March 2010, the president signed into law a sweeping overhaul of the health care system. Almost everyone in the United States will be affected by these changes—individuals, insurance companies, health care providers, and employers. The three primary goals of the reform are to expand coverage to those without health insurance, reform the delivery system of benefits to improve quality, and decrease the costs of providing health care. The various provisions of the reform will become effective over time, through 2020. The new laws contain many changes for employers to consider for financial reporting purposes, in addition to many new tax rules to help offset the overall cost of the reform.

.39 The complete changes are contained in two acts. The Health Care and Education Reconciliation Act of 2010 was signed on March 30 and is a reconciliation bill that amends the PPACA signed into law by the president one week earlier. In April, the SEC issued a staff announcement, *Accounting for the Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act*, to address questions that have arisen about the effect, if any, that the different signing dates might have on accounting for the two acts. This timing difference, related solely to the signing dates, should not have an impact on a majority of registrants because the acts were both signed within a relatively short time period, which for the vast majority of entities, falls into the same reporting period. However, there may be a limited number of registrants with a period-end that falls between the signing dates for which the timing difference could raise questions about whether the different signing dates have an accounting impact.

.40 After consultation with the Financial Accounting Standards Board (FASB) staff, the Office of the Chief Accountant would not object to a view that the two acts should be considered together for accounting purposes. That is, in this specific fact pattern, the SEC staff would not object to a registrant incorporating the effects of the Health Care and Education Reconciliation Act of 2010 when accounting for the PPACA. This view is based in part on the SEC staff's understanding that the two acts, when taken together, represent the current health care reform as passed by Congress and signed by the president. The SEC staff does not believe that it would be appropriate to analogize to this view in any other fact patterns.

Significant Accounting and Tax Considerations

.41 FASB *Accounting Standards Codification* (ASC) 740-10-30-2 states that the following basic requirements are applied to the measurement of current and deferred income taxes at the date of the financial statements:

- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets (DTAs) is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

.42 FASB ASC 715-60-35-102 further explains that benefit coverage for medical claims by governmental programs or other providers of health care benefits should be assumed to continue as provided by the present law and other providers, pursuant to their present plans. Consistent with FASB ASC guidance, presently enacted changes in the law or amendments of the plans of other health care providers that take effect in future

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periods and that will affect the future level of their benefit coverage should be considered in current period measurements for benefits expected to be provided in those future periods. Future changes in laws concerning medical costs covered by governmental programs and future changes in the plans of other providers should not be anticipated.

.43 The two primary accounting considerations resulting from this reform are the effects of the tax law changes on deferred income tax balances and other postretirement health benefits. One of the most significant changes relates to the government subsidy for providing qualifying prescription drug coverage to Medicare-eligible retirees becoming an offset for prescription drug income tax deductions. Specifically, because entities will need to reduce their income tax deduction for providing prescription drug coverage by the subsidy received, they currently need to record a charge to earnings to write off a portion of their DTAs related to postretirement health care obligations. Such DTAs were based on the gross liability amount. Because the tax deductible prescription drug costs liability will be reduced by the subsidy, the DTA will be computed net of the subsidy, resulting in a lower DTA. The federal subsidy will not reduce the tax deductions until 2013. Even though the changes may not be effective until future periods, the effects are accounted for in the period that includes the enactment date. FASB ASC 715-60 discusses accounting and reporting guidance for other postretirement plans, including the Medicare prescription drug plan. Many public entities have already posted large noncash charges in early 2010 related to the nondeductibility of the subsidy.

.44 Some of the other provisions of the reform that may affect an entity's tax position include the nondeductible pharmaceuticals fee, the medical device excise tax, and the therapeutic discovery project tax credit, which will have an effect on the pharmaceutical and medical device industries. Additionally, employer group health plans may not impose lifetime limits and can only impose "restricted" annual limits beginning with the 2011 plan year (for calendar year plans); no annual limits would be permitted beginning in 2014. Because these health benefits can no longer be limited, entities may need to increase accruals for future medical obligations. Many small businesses and tax-exempt organizations that provide health insurance coverage to their employees will now qualify for a special tax credit that is designed to encourage small employers to offer health care coverage for the first time or maintain the coverage they have. Lastly, under the new reform, a 40 percent penalty will apply to tax understatements attributable to transactions lacking economic substance (20 percent with adequate disclosure) or failing to meet the requirements of any similar rule of law. A transaction is treated as having economic substance only if the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

.45 In July 2010, the NAIC adopted a new annual statement reporting supplement to record the comprehensive major medical health insurance business for large group employers, small group employers, and individual plans. The supplement will assist state and federal regulators in identifying and analyzing the medical loss ratio for comprehensive major medical health insurance as required under the PPACA. As currently designed, the supplement will initially be filed with the NAIC by applicable insurers on April 1, 2011, based on the calendar year results as of December 31, 2010. The results of the April 1 filing will not be used for calculating rebate information but will be used by regulators as a preliminary view of results. A second filing June 1 or thereafter will be submitted based on claims development after the December 31, 2010, reporting date. A materiality threshold was included for filing the supplement that would exempt insurers that write no comprehensive major medical coverage, that only have major medical coverage in run-off with only claims and no premiums, and if their major medical premium on Schedule T is less than 2 percent of total premiums.

.46 The full text of these acts can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ152.111.pdf and http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_ laws&docid=f:publ148.111.pdf. Readers are also encouraged to refer to the Audit Risk Alerts *Health Care Entities—2010/11* (product no. 0223410) and *Not-for-Profit Entities—2010* (product no. 0224210).

PCAOB Constitutionality

.47 On June 28, 2010, the Supreme Court ruled in the lawsuit challenging the constitutionality of the PCAOB. When the PCAOB was set up under SOX, its board members were appointed by the SEC and could

be removed only for cause. The Supreme Court ruled, in a 5-4 vote, that although the manner in which the PCAOB was constituted was constitutionally invalid, SOX itself was not invalidated. Rather, the Supreme Court severed from the rest of SOX the provisions relating to the removal of PCAOB board members. The consequence of the Supreme Court's decision is that PCAOB board members will now be removable by the SEC at will, instead of only for good cause. Essentially, this decision has no material impact on the workings of the PCAOB, and all PCAOB programs will continue to operate as usual, including registration, enforcement, and standard-setting activities.

Recent Statutory Accounting Principles

.48 The NAIC continues to develop and clarify statutory accounting guidance for insurance enterprises through its ongoing maintenance process. The most recent *Accounting Practices and Procedures Manual* was published by the NAIC as of March 2010 and contains accounting practices and procedures adopted by the NAIC through March 2010. Updates to the manual can be found under the Statutory Accounting Principles Working Group section of the NAIC website. Insurance laws and regulations of the state insurance departments require insurance entities domiciled in those states to comply with the guidance provided in the manual, except as otherwise prescribed or permitted by state law or regulation.

.49 The 2010 manual contains four new Statements of Statutory Accounting Principles (SSAPs) that were adopted through March 2010:

- SSAP No. 10R, *Income Taxes—Revised, A Temporary Replacement of SSAP No. 10*. SSAP No. 10R was adopted in December 2009 to revise the calculation of DTAs. The new provisions increase the admissibility limits for the carryback and realization period from 1 year to 3 years and surplus limitation from 10 percent to 15 percent. A requirement was added to disclose an adjustment to gross DTAs for a statutory valuation allowance if it is "more likely than not" that some portion of the DTA will not be realized. Further, RBC guardrails were instituted to prohibit taking the incremental DTA under the new provision unless certain RBC thresholds were met—that is, 250 percent for life companies and 300 percent for property and casualty companies. Certain non-RBC filers, such as title, financial guaranty, and mortgage guaranty insurers, were excluded from recording the additional DTA under the new guidance. SSAP No. 10R is effective for annual periods ending December 31, 2009, with a sunset after December 31, 2010. As of September 2010, there is a proposal to extend the sunset date through December 31, 2011, and to require expanded disclosure concerning the use of tax planning strategies in determining the admissibility of DTAs.
- SSAP No. 62R, *Property and Casualty Reinsurance (Revised)*. SSAP No. 62R was adopted in December 2009 to allow prospective reinsurance accounting for the transfer of property and casualty run-off transactions when specific criteria are in place, including approval by the domiciliary regulators of the transferring entity and the assuming entity. The changes are effective for transactions entered into after January 1, 2010.
- SSAP No. 100, *Fair Value Measurements*. SSAP No. 100 was adopted in December 2009 and defines *fair value* for statutory financial reporting, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. With the adoption of this SSAP, several nonsubstantive revisions were made to other SSAPs and interpretations to reflect the new guidance. This SSAP nullifies Interpretation 09-04, *Application of the Fair Value Definition*.
- SSAP No. 43R, *Loan-Backed and Structured Securities (Revised)*. SSAP No. 43R was adopted in September 2009. SSAP No. 43R modifies statutory accounting principles for investments in loan-backed and structured securities. The guidance specifies that if the insurer determines there has been an other-than-temporary impairment and either intends to sell the loan-backed or structured security, or if it does not have the intent and ability to retain the investment for the time sufficient to recover the amortized cost, the security is written down to fair value. If the insurer does not expect to recover the entire amortized cost basis of the security when it does not intend to sell the security, and it has the intent and ability to hold the security, the amount of the other-than-temporary impairment recognized as a realized loss shall equal the difference between the investment's amortized cost basis and the present value of cash flows expected to be collected and discounted at the effective interest rate in accordance with paragraph 32 of SSAP No. 43R.

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.50 SSAP No. 43R specifies transition guidance for insurers that accounted for loan-backed and structured securities under SSAP No. 43; SSAP No. 98, *Treatment of Cash Flows When Quantifying Changes in Valuation and Impairments, an Amendment of SSAP No. 43*, through early adoption; or had an accounting policy in accordance with the prescriptions of SSAP No. 98.

.51 Several nonsubstantive revisions to various SSAPs and manual appendixes were made during 2009 and 2010 by the NAIC. Interpretations are immediately effective upon adoption by the NAIC, and new SSAPs occasionally are effective for the calendar year in which they are adopted.

.52 Actuarial Guideline XLIII (AG 43), CARVM for Variable Annuities, also known as VA CARVM (Variable Annuity Commissioners Annuity Reserve Valuation Model), is a new statutory reserve standard for variable annuity products with guaranteed death and living benefits and was effective as of December 31, 2009. The scope of AG 43 includes all individual and group, deferred, and immediate variable annuities. The reserve calculation includes a standard scenario floor and likely will result in higher statutory reserves than under the current requirements. It provides more specific reserves in respect of modern products and thus it applies to variable annuities and other contracts that provide a guaranteed life benefit to the policyholder while the policyholder is alive, such as guaranteed income benefits and guaranteed withdrawal or accumulation benefits.

.53 Life and health actuaries in the United States are in the process of moving to a principles-based approach for statutory reserves through changes to the standard valuation law. The approach produces reserves that are the result of stochastic calculations but are subject to a minimum of a standard scenario. The approach moves away from a methodology that is the same for all companies to one that is more company specific and takes account of the specific assets backing the liabilities and the extent to which these assets are hedged to take account of changes in the liabilities owing to market movements. Although the methods are more company specific, the assumptions will have to be based on either credible company experience or industry norms.

.54 The approach will be flexible in that the law will point to a valuation manual that is in the process of being finalized. The valuation manual will be quickly updated to keep pace with changing conditions.

.55 The intent of the change was to enable regulators to focus on those insurers likely to be the subject of actual or potential problems and to use a risk analysis methodology to focus on the environment in which the company operates, the company's financial metrics, and the extent and effectiveness of the company's controls and risk management. Auditors should evaluate the company's methodology and assumptions, including the credibility of the data underlying the company's assumptions.

.56 After six years of work by the American Academy of Actuaries, regulators, and interested parties, the NAIC Life and Health Actuarial Task Force exposed for comment a new draft of Chapter 20 of the Valuation Manual (VM-20), the principle-based reserve requirements for life products, at the NAIC Summer Meeting in August 2010. The next step will be the development of metrics through a field testing and impact study that the NAIC will begin in September 2010.

The NAIC's Sarbanes-Oxley Initiative Update

.57 The NAIC adopted changes to the Annual Financial Reporting Model Regulation (also known as the Model Audit Rule, or MAR) related to SOX during its fall 2006 meeting, with the majority of the changes effective for 2010. Through August 2010, all states have adopted the revised MAR. The District of Columbia plans to have adoption completed by the end of 2010. Readers should be aware that some states have adopted slight variations of the revised MAR. It is recommended that readers become familiar with the terms of adoption by the domiciliary states of their entities or insurance clients.

.58 Highlights of the significant changes to the current MAR related to SOX include the following:

- *Section 7*: The time allowed to serve in the capacity as the lead or coordinating audit partner was decreased from seven years to five consecutive years with a new five year break in service (previously two years), effective beginning with year 2010 statutory audits.
- *Section 7*: A list of nonaudit services that cannot be performed by the auditor (the prohibitions generally agree with those designated by the SEC), effective for the year 2010 statutory audits. Insurance entities with less than $100 million in direct written and assumed premiums may request an exemption from this requirement.
- *Section 9*: To the extent required by AU section 319, *Consideration of Internal Control in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), for those insurers required to file a management's report on internal control over financial reporting pursuant to Section 16 (see the following "Section 16" bullet point), the independent CPA should consider the most recently available report in planning and performing the audit of statutory financial statements.
- *Section 11*: Auditors should prepare a written communication of any unremediated material weaknesses that the insurer will furnish the domiciliary commissioner, effective beginning with year 2010 statutory audits. The current MAR requires the auditor to prepare a report of significant deficiencies and material weaknesses in the insurer's internal control structure noted by the auditor during the audit.
- *Section 14*: New specifications for the responsibilities of audit committees and the required qualifications of audit committee members will be effective January 1, 2010. The adopted revisions require that insurance entities have an audit committee that is solely responsible for the appointment, compensation, and oversight of the entity's auditor. The guidance also indicates that some audit committees, based on the insurer's premium volume, would need to comprise a certain percentage of individuals who are independent from management. The premium threshold that triggers the requirement for independent audit committee members is $300 million assumed and direct premiums. The premium range for a majority (50 percent or more) of independent audit committee members is from $300 million to $500 million. The requirement for a supermajority (75 percent or more) of independent audit committee members is $500 million in premiums. Notwithstanding premium volume, all insurers are encouraged to structure their audit committees with at least a supermajority of independent audit committee members.

  Entities meeting certain requirements may request an exemption from their domiciliary commissioner based on hardship. Examples include requests based on the business type of the entity, the availability of qualified board members, or the ownership or organizational structure of the entity.
- *Section 16*: Every insurer required to file an audited financial report that has an annual direct written and assumed premium of $500 million or more shall prepare a report of the insurers' or group of insurers' internal control over financial reporting and file it with their insurance commissioner, effective December 31, 2010. The MAR also includes a list of what should be included in management's report on internal control over financial reporting. This report is prepared by management and is not audited. An insurer that is a SOX-compliant entity or is a direct or indirect wholly owned subsidiary of a SOX-compliant entity will be able to file its or its parent's SOX Section 404 report in satisfaction of this Section 16 requirement. However, an addendum also needs to be filed with the SOX Section 404 report that would include a positive statement that no material processes exist related to the preparation of the audited statutory financial statements that were excluded from the SOX Section 404 report. If internal controls exist that have a material impact on the preparation of the audited statutory financial statements excluded from the SOX Section 404 report, they need to be addressed. The insurer may either file a report under Section 16, or the insurer can file its SOX Section 404 report and a Section 16 report for those internal controls that would have a material impact on the audited statutory financial statements and were not covered by the SOX Section 404 report.

  The independent CPA should consider this report during the planning and performance of the annual audit. In addition, the revisions require the insurer to file with the state insurance department the

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independent public accountant's communication regarding any unremediated material weaknesses noted during the course of the audit.

- *Section 17*: An insurer may make written application to the commissioner for waiver from any or all provisions of the model based upon financial or organizational hardship. For example, the commissioner could, under this section, grant a waiver of the Section 14B audit committee independence requirements to an entity exceeding the $500 million premium threshold, even though the Section 14H waiver would not apply. This exemption is granted at the discretion of the commissioner and may be granted at any time for a specified period or periods.

.59 Please note the Implementation Guide for the MAR included in Appendix G of the 2010 *Accounting Practices and Procedures Manual* was not the final version that was adopted in December 2009; the final version can be found on the NAIC/AICPA Working Group's website at www.naic.org/committees_e_naic_aicpa_wg.htm.

Risk-Focused Statutory Examinations

.60 Entities are examined for regulatory purposes by the domestic insurance departments for financial solvency. State regulators perform their financial examinations using the risk-focused surveillance approach outlined in the NAIC *Financial Condition Examiners Handbook*. A need existed for a broader entitywide business risk assessment, focusing on strategic and operational issues, which enhances the process for evaluating the solvency risks inherent in an insurer's operations. As a result, effective January 1, 2010, state examiners are required to conduct their examinations using the risk-focused surveillance approach.

.61 This examination approach, a key component of establishing and operating an effective risk-focused surveillance process, involves several differences from the traditional, more substantive-based statutory examination process. In particular, under the risk-focused approach, heavy emphasis is placed on the insurer's corporate governance and established risk management practices and processes. At the beginning of the examination, regulators gain an understanding of the corporate governance structure and assess the "tone at the top." In addition, examiners obtain information on the quality of oversight provided by an entity's board of directors. Examiners also evaluate and assess the effectiveness of senior management as part of this corporate governance assessment process. All of this information contributes to an understanding of how an entity identifies, controls, monitors, mitigates, evaluates, and responds to its business risks. This assessment helps determine the most significant financial reporting and prospective risk areas and assists with determining the amount of substantive examination procedures that state examiners should perform. The examiner's review and consideration of prospective business risk is designed to focus on key risks to future solvency and allows the regulators to tailor their supervision plan to address key risks.

.62 Among others, the purposes of the risk-focused examination process include the following:

- Detecting early those insurers with potential financial trouble.
- Identifying instances of noncompliance with state statutes and regulations.
- Compiling the information needed for timely, appropriate regulatory action.
- Providing a clearer methodology for assessing residual risk in each key activity under review with an explanation of how that assessment translates into establishing examination procedures.
- Allowing for the assessment of an insurer's risk management processes in addition to those that result in financial statement line item verifications (that is, other than financial statement risks). For example, the effectiveness of an entity's board of directors and other corporate governance activities would provide an introspective look at the operations and quality of the risk management processes of the insurer.
- Allowing for the utilization of examination findings to establish, verify, or revise the entity's priority score, determined through the department's analysis and utilization of the NAIC tools (for example, Scoring System, Analyst Team System Review results, and Insurance Regulatory Information System ratios).

.63 In conjunction with the previously explained objectives, the examiners could review the independent auditor's testing, the assessment relative to the insurer's corporate governance environment, or both, recognizing that the extent of documentation pertaining to the insurer's corporate governance structure and risk mitigation strategies will vary based on the size and structure of the entity and its holding company group. If the external auditor has reviewed the enterprise risk management (ERM) practices and the potential relationship to the Committee of Sponsoring Organizations of the Treadway Commission's ERM framework (or other ERM frameworks such as the ISO 31000 or the Australia/New Zealand risk management frameworks), the examiner likely will be interested in reviewing this documentation. In addition, the examiners also will make inquiries of an entity's external auditor regarding various substantive testing procedures associated with the auditor's balance sheet and income statement account testing.

.64 The evaluation of internal control of an entity's information technology is a critical element of the risk-focus examination process because the accuracy of the financial statement information depends on the programs and the data files from which they are produced. Smaller entities, as well as those entities that are subject to the requirements of SOX Section 404 or MAR will be expected to proactively address information technology risks. Determining the complexity of an entity's IT environment and determining the extent of work that must be performed to evaluate the controls of the system is not always straightforward. Knowledge gained about systems during previous examinations may no longer be relevant if systems have been refreshed or replaced. An evaluation of an IT environment should consider the elements of internal control in information systems, including general controls over the development of and changes to computer programs, data file access, and application controls over the results of computer processing. The regulators may be particularly interested in the scope of IT testing performed by both the external auditor and the entity on key controls related to both general computer and application controls. In smaller entities, the external auditor's work in this area also may be considered important because of cost constraints.

.65 Furthermore, the increased understanding in the insurer's corporate governance and established risk management practices and processes will help determine the most significant financial statement and prospective risk areas. Once the examiners determine the most significant financial reporting areas of focus, they may be interested in reviewing the external auditor's testing of certain key internal controls related to the entity's compliance with SOX Section 404 or MAR in order to determine the potential leverage of the external auditor's working papers into the examiner's test plans. The risk and control matrices that outline the significant risks, key controls, financial statement assertions, testing performed, results of testing, and conclusions reached regarding the design and operating effectiveness of such controls will be of particular interest to the examiners. The regulators likely will want to understand the scope of internal control testing performed by the external auditors and may review or reperform certain aspects of the external auditor's internal control testing in order to establish a basis for reliance. Most entities will want their external auditors to cooperate with the state insurance regulators in order to avoid duplication of effort relating to the testing of key financial statement controls.

.66 Timing with regard to when the external auditor's working papers are made available to the examiners is also an important area to consider in terms of effective coordination. As examiners begin planning their examination scope in phase 1 of the risk-focused examination process, one of the first areas considered is access to the CPA's working papers. In order to leverage efficiencies, access to the CPA's work is a critical step for the examiner in the planning or scoping process. Wherever possible, access to draft or interim working papers, or working papers in particular areas only, may be useful to the examiner to (1) expedite the coordination process, (2) avoid potential redundancy of testing with the external auditor, and (3) maximize efficiencies in terms of leverage of the auditor's prior testing. All of these areas help streamline the examination process for the examiners, auditors, and companies examined.

Insurance Industry-Related Federal Initiatives

Treasury Department's Financial Regulatory Reform

.67 The Dodd-Frank Act involves significant restructuring of the regulation system, including the creation of new agencies (while merging and eliminating others). Important new agencies created include the Office

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of Financial Research,[1] the BCFP,[2] and the FSOC,[3] which is chaired by the Treasury and includes the principal federal financial regulators. The act includes two major insurance components: (1) to advance national coordination in the insurance sector, the act includes creation of a Federal Insurance Office (FIO) within the Treasury Department; and (2) to streamline state-level surplus lines and reinsurance regulation, the act includes provisions to eliminate inefficiencies associated with surplus lines insurance and reinsurance.

.68 For surplus lines, these provisions include the home state of the insured having exclusive authority to regulate the placement of nonadmitted insurance and collect premium taxes as well as the establishment of uniform standards for surplus lines eligibility criteria, among others. For reinsurance, the provisions establish the ceding insurer's state of domicile as the single point of regulation on a number of fronts, including credit for reinsurance, dispute resolution, reinsurance contract terms, and choice of law, among others, providing that the state is NAIC-accredited or has financial solvency requirements substantially similar to those requirements. Also, the provisions establish the reinsurer's state of domicile as the insurer's solvency regulator, providing that it is an NAIC-accredited state, and other states will be precluded from requiring financial information other than what the domiciliary state requires.

.69 Regarding the FIO, it will be led by a director appointed by the secretary and is the first federal agency with responsibility for understanding and advising policy makers on a broad range of insurance issues. Although the authority granted to the FIO falls short of a regulatory role, the FIO is tasked with

- monitoring all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers that could contribute to a systemic financial crisis in the insurance industry or the U.S. financial system.
- monitoring the extent to which traditionally underserved communities and consumers, minorities, and low- and moderate-income persons have access to affordable insurance products regarding all lines of insurance except health insurance.
- assisting the secretary in administering the $100 billion Terrorism Insurance Program established under the Terrorism Risk Insurance Act of 2002.
- recommending to the FSOC that it designate an insurer, including affiliates, as an entity subject to regulation as a nonbank financial company supervised by the board of governors pursuant to Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- coordinating federal efforts and establish federal policy on prudential aspects of international insurance matters, including representing the United States in the International Association of Insurance Supervisors and assisting the secretary in negotiating international insurance agreements.
- determining whether state insurance measures are preempted by covered agreements.
- preempting state laws that conflict with international trade agreements, but only to the extent those laws discriminate against foreign-domiciled entities with an agreement or treaty with the United States.
- as a key responsibility, collecting and analyzing data about the insurance markets, using subpoena power, if necessary, and providing Congress and the White House with regular annual reports commencing September 30, 2011. Smaller entities meeting a minimum size threshold would earn an exemption from the data collection process. The act includes specific confidentiality guarantees that the government will not spill any trade secrets. In addition, in advance of requesting and collecting data from the insurance industry, it will coordinate with each relevant state or federal regulator to determine whether the information to be collected is obtainable and timely available from such regulator.

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[1] For a detailed description of this office, see http://en.wikipedia.org/wiki/Dodd%E2%80%93Frank_Wall_Street_Reform_and_Consumer_Protection_Act#Office_of_Financial_Research.

[2] For a detailed description of this bureau, see http://en.wikipedia.org/wiki/Bureau_of_Consumer_ Financial_Protection#Title_X_-_Bureau_of_Consumer_Financial_Protection.

[3] For a detailed description of this council, see http://en.wikipedia.org/wiki/Dodd%E2%80%93Frank_Wall_Street_Reform_and_Consumer_Protection_Act#Financial_Stability_Oversight_Council.

- consulting with the states regarding insurance matters of national importance and prudential insurance matters of international importance.
- using authority that would extend to all lines of insurance including reinsurance but excluding health insurance, crop insurance, and long-term care insurance (to the extent that long-term care insurance includes an annuity component, the FIO will be empowered to oversee it).

.70 There has been much debate about the merits of moving to a dual regulatory system for insurers. As of this writing, an optional federal charter (OFC) is not a certainty. Legislation was previously introduced in both the House and the Senate supporting the establishment of an OFC. Some insurers that previously supported an OFC measure have publicly indicated a change in position or are reevaluating their support in light of the act. If one were to be approved by Congress, it is not expected to apply to health insurance but would possibly apply to both property and casualty insurance and life insurance lines of business, although it could ultimately apply only to life insurance. The state-based system would continue for those deciding not to operate at the national level. Although the act does not include a federal charter component, it does require that the director of the FIO conduct a study and submit a report to Congress within 18 months of enactment on how to modernize and improve the system of insurance regulation in the United States. The study will consider a number of factors, including

- consumer protection for insurance products and practices, including gaps in state regulation;
- the degree of national uniformity of state insurance regulation;
- the costs and benefits of potential federal regulation of insurance across various lines of insurance (except health insurance); and
- the ability of any potential federal regulator to provide robust consumer protection for policyholders.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.71 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients. Some risks that may affect an entity in the current economic environment include the following:

- Marginally achieving explicitly stated strategic objectives
- Volatile real estate and business markets
- Significant measurement uncertainty, including accounting estimates and fair value measurements
- Potentially erroneous or fraudulent activity due to decreased staffing and resurgence of business activity
- The continuing evolution of the postrecessionary marketplace

.72 Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

.73 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

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Reinsurance Contracts

.74 Auditors of entities with significant reinsurance contracts may want to request that management state in its representation letter that the auditor has been informed of any side agreements that are part of reinsurance contracts, for the purpose of determining whether the entity has considered properly these agreements in the accounting analysis for the contract. Auditors also may consider the guidance in AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when evaluating these arrangements to identify the following:

- Contracts backdated to avoid retroactive reinsurance accounting on coverage of losses that had already been incurred
- Side agreements to reimburse the reinsurer for covered losses or to return profits under a contract in a different accounting period, which may compel accounting accruals
- Linked contracts through which losses experienced under one will be reimbursed under another in the future and which should be considered together in the risk transfer analysis
- Contracts whose terms do not make economic sense and indicate a side agreement, or linkage, with another contract that should be considered in the accounting evaluation
- Exclusive reinsurance arrangements with offshore assuming companies that raise consolidation questions
- Commutations in which the settlements are not in accordance with contract terms and suggest a noncontractual agreement on the allocation of profits and losses
- Contracts under which the risk transfer analysis supporting the accounting evaluation differs materially from and cannot be reconciled to cash flow analyses included in the underwriting file

Reinsurance Recoverables

.75 Consideration should be given to the terms of the reinsurance agreements and the creditworthiness of the reinsurer. Significant payment terms may be material to liquidity and required capital levels. Auditors should refer to AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1). Due to a continued downturn in the market, the auditor should give significant consideration to whether the entity complies with regulatory RBC requirements when evaluating an insurance entity's ability to continue as a going concern.

Claims Expense and Loss Reserves

.76 Due to the increased number and complexity of transactions surrounding claims and claim expenses, inherent risk surrounding the recording and payout of claims can increase. Auditors should evaluate their client's response and adherence to criteria and related controls surrounding expenses.

.77 The identification of changes surrounding valuation variables and consideration of their effect on losses are critical audit steps. The evaluation of these factors includes the involvement of specialists and input from various operating departments within the entity, such as marketing, underwriting, actuarial, reinsurance, and legal. Readers should remember that losses are only accrued for events that have occurred; catastrophe reserves are not allowed in anticipation of events.

.78 AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1), states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements (additional discussion in the "Auditing Accounting Estimates" section of this alert). Claims expense and loss reserve estimates are significant variables on an insurance entity's financial statements. Accordingly, regardless of the approach used to audit claims expense and loss reserve estimates, the auditor should gain an understanding of how management develops estimates. Additionally, chapter 4, "The Loss Reserving and Claims Cycle," and appendix A, "Additional Audit Considerations for Loss

Reserves, Premiums, Claims, and Investments," of the AICPA Audit and Accounting Guide *Property and Liability Insurance Entities* are additional sources of guidance.

.79 Auditors also can refer to AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1) (additional discussion in the "Using the Work of a Specialist" section of this alert), as well as noting current practitioner prohibitions and restrictions that exist related to the performance of nonaudit services for audit clients, including certain actuarial services. Practitioners should be aware of and comply with these prohibitions and restrictions, including the AICPA, SEC, and PCAOB independence rules; new NAIC rules describing qualifications of an independent CPA included in the MAR effective for 2010 statutory audits; and rules passed by the U.S. GAO, state licensing boards, and others.

Auditing Accounting Estimates

.80 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert discusses fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, impairment analysis and estimated useful lives of long lived assets, certain insurance liabilities and assets, valuation allowance for DTAs, and actuarial assumptions in pension and other postretirement benefit costs.

.81 Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

.82 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet earnings, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management's accounting estimates with an extra degree of professional skepticism. As noted by AU section 316, when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.83 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342. The AICPA has released a proposed redrafted Statement on Auditing Standards (SAS), *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures (Redrafted)*, on auditing accounting estimates, including fair value. Readers are encouraged to remain alert for developments on this topic.

Using the Work of a Specialist

.84 It may be necessary to use a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336 provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm

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participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), is applicable rather than AU section 336.

.85 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements. In July 2010, the PCAOB issued Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06), because it observed that a number of registered public accounting firms located in the United States have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the United States. Auditors of issuers should consult this practice alert for reminders concerning their obligations when using the work of other firms or using assistants engaged from outside the firm, such as in the aforementioned situation.

PCAOB Auditing Standards on Risk Assessment

.86 In August 2010, the PCAOB adopted a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit. These standards were initially proposed in late 2008 and reproposed in late 2009. These risk assessment standards will benefit investors by setting forth requirements that enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. They are applicable to audit procedures spanning from the initial planning stages of the audit to the evaluation of the audit results. Improvements in the risk assessment standards should enhance integration of the audit of financial statements with the audit of internal control over financial reporting by articulating a process for identifying and assessing risks of material misstatements that apply to both portions of the integrated audit.

.87 The new auditing standards, with a brief description of each, are as follows:

- Auditing Standard No. 8, *Audit Risk*, discusses the auditor's consideration of audit risk in both an integrated audit and an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing it to an appropriately low level.
- Auditing Standard No. 9, *Audit Planning*, establishes requirements for planning an audit, such as assessing important matters and establishing an appropriate audit strategy.
- Auditing Standard No. 10, *Supervision of the Audit Engagement*, is applicable to the engagement partner and other team members who supervise during the audit. It sets forth requirements for supervision of the audit engagement and the work of other engagement members. Related to this topic, the PCAOB also recently issued a release discussing the provision of SOX that authorizes the PCAOB to impose sanctions on registered public accounting firms and their supervisory personnel for failing to reasonably supervise associated persons.
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements for auditors in identifying and assessing risks of material misstatement, including information-gathering procedures.
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements for responding to those identified risks of material misstatement through general audit procedures. It also includes audit procedures related to significant accounts and disclosures.
- Auditing Standard No. 14, *Evaluating Audit Results*, establishes requirements for evaluating audit results and the sufficiency of appropriate audit evidence.

- Auditing Standard No. 15, *Audit Evidence*, discusses what constitutes audit evidence and how to design and perform audit procedures to support the opinion expressed in the auditor's report.

.88 These risk assessment standards will supersede the following six PCAOB interim standards and related amendments: AU section 311, *Planning and Supervision*; AU section 312, *Audit Risk and Materiality in Conducting an Audit*; AU section 313, *Substantive Tests Prior to the Balance Sheet Date*; AU section 319; AU section 326, *Evidential Matter*; and AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). The standards, if approved by the SEC, will be effective for audits of fiscal periods beginning on or after December 15, 2010.

.89 In September 2010, the SEC published *Notice of Filing of Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* to solicit comments on the proposed rules. This notice was posted in the *Federal Register* on September 27, 2010. Comments were due 21 days from the publication of the notice in the *Federal Register*, and the SEC will take action on the proposed rules 90 days from the publication of the notice in the *Federal Register*.

Engagement Quality Review for Issuers

.90 In January 2010, the PCAOB announced that the SEC had approved Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which was adopted by the PCAOB in July 2009. Auditing Standard No. 7 provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. Auditing Standard No. 7 is expected to increase the likelihood that a registered public accounting firm will catch any significant deficiencies before it issues its audit report. As a result, more work may be necessary under this standard than performed under the existing requirements for concurring partners. However, Auditing Standard No. 7 explains that the procedures required by the engagement quality reviewer are different in nature than those required to be performed by the engagement team. Further, if the engagement quality reviewer deems more work is required before giving approval of issuance, the engagement team is responsible for completing that work.

.91 This standard applies to all audit engagements, and engagements to review interim financial information, conducted pursuant to the standards of the PCAOB, and it supersedes the PCAOB's interim concurring partner review requirement. Auditing Standard No. 7 is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009. For a public, calendar-year company, this standard is applicable for the quarter ended March 31, 2010. Subsequent to the issuance of Auditing Standard No. 7, the PCAOB issued Staff Question and Answer *Auditing Standard No. 7*, Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10) to provide further implementation guidance on the documentation requirements of the standard. For the full text of the standard and the question and answer, readers are encouraged to visit the PCAOB's website at www.pcaob.org.

Supplementary and Other Information Related to Financial Statements

.92 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Auditing Fair Value Measurements

.93 In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of

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equity are measured or disclosed at fair value in the financial statements, and it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with U.S. generally accepted accounting principles (GAAP), auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

.94 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB ASC 820, *Fair Value Measurements and Disclosures*, under U.S. GAAP this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.
- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)
- The reasonableness of the determination within the fair value hierarchy of inputs.

Fair Values of Securities

.95 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation

assumptions that are highly subjective. In the context of FASB ASC 820, quoted prices in active markets are considered level 1 inputs.

.96 When an entity performs its own valuation, value testing procedures include the following:

- Assessing the reasonableness
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

.97 Whether the inputs to the entity's valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB ASC 820. When extensive judgment is needed, consider using a specialist or refer to AU section 342. Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.98 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles. The auditor also should evaluate management's conclusions regarding other-than-temporary impairment on its securities. Examples of factors that could cause an other-than-temporary impairment, per paragraph .47 of AU section 332, include the following:

- Fair value is significantly below cost and
  - — the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - — the decline has existed for an extended period of time.
  - — management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

.99 Auditors should consider all facts and circumstances when determining if an other-than-temporary impairment has occurred. Additionally, the classification of an entity's securities is based on management's intent and ability. The auditor should obtain an understanding of management's classification process among trading, available-for-sale, and held-to maturity, as well as consider the classifications in light of the entity's current financial position.

Communicating Internal Control Related Matters Identified in an Audit

.100 SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), supersedes SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, and further clarifies standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted.

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.101 The SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion), except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1). In general, SAS No. 115 retains many of the provisions of SAS No. 112. The key differences between the two standards lie in the definitions of *material weaknesses* and *significant deficiencies*.

Definitions of Significant Deficiency *and* Material Weakness

.102 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable*, as those terms are defined in the FASB ASC glossary. The FASB ASC glossary defines *reasonably possible* as when the chance of the future event or events occurring is more than remote but less than likely; *probable* is defined as when the future event or events are likely to occur. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

The Evaluation Process

.103 Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. Further, the severity of a deficiency does not depend on whether a misstatement actually occurred.

.104 The AICPA published the Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Service Organizations

.105 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324) has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801), contains the requirements for reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324. Once the new SAS becomes effective, it will replace the guidance for user auditors currently in AU section 324. SSAE No. 16 is based on the International Auditing and Assurance Standards Board's (IAASB's) International Standard on Assurance Engagements No. 3402, *Assurance Reports on Controls at a Service Organization*, and the new SAS is based on the IAASB's

International Standard on Auditing (ISA) 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

.106 The AICPA is in the process of overhauling and rewriting the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (commonly known as the SAS 70 guide). Also, to address reporting on a service provider's controls over subject matter other than financial reporting, the AICPA is developing a new Audit Guide, *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*. Both guides are expected to be available for sale in early 2011. The AICPA is also in the process of drafting communication materials that will help auditors, clients, and users understand the three types of service organization control (SOC) reports (formerly SAS No. 70 reports) to be used for reporting on these engagements.

	Title	*Description*
SOC 1	*Report on Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting*	To be used only in circumstances when the service organization's services and controls affect the internal control over financial reporting for the entities that use the service.
SOC 2	*Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, and Privacy*	The purpose is to convey trust and assurance to users of the system that the service organization has deployed an effective control system to effectively mitigate operational and compliance risks that the system may represent to its users.
SOC 3	*Trust Services Report*	These reports are designed to meet the needs of users who want assurance on the controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy of a system but do not have the need for the level of detail provided in an SOC 2 report. These reports are general use reports and can be freely distributed or posted on a website as a seal.

Compilation and Review Engagements

.107 The AICPA developed a brand new guide, *Compilation and Review Engagements*, which provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

Accounting Issues and Developments

.108 Given the current economic climate, auditors should consider a number of accounting and financial reporting issues, such as the following:

- Fair value, including fair value measurements in illiquid markets
- Impairment
- Liquidity restrictions

.109 In addition to economic conditions, external forces, such as natural disasters, significantly affect the insurance industry, especially property and liability insurance entities. Although many of these risks are not new to business, consideration of the many ways a client is affected by external forces is part of obtaining an

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understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks.

FASB Statement No. 168

.110 FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, as codified in FASB ASC 105, *Generally Accepted Accounting Principles*, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in their financial statements.

Referencing FASB ASC in Your Documentation

.111 You should consider how your entity will reference FASB ASC in your documentation (policy and procedures, technical memorandums, financial statements and filings, engagement working papers, and so on). It is only prudent to reflect current U.S. GAAP in your documentation. The FASB Notice to Constituents includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*." Conversely, FASB suggests using the detailed numerical referencing system in working papers, articles, textbooks, and related items.

.112 Also, because FASB ASC is not intended to change U.S. GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate. It is prudent to expect that audit, attest, or compilation and review working papers associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

.113 However, if your entity will continue to follow grandfathered guidance not included in FASB ASC, it would still be appropriate to reference those standards (and not FASB ASC). A listing of examples of grandfathered guidance can be found in FASB Statement No. 168.

.114 Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/FASBAccountingStandardsCodification.aspx.

Postcodification FASB References

.115 In spring 2010, the AICPA judgmentally selected 50 SEC filers and reviewed their 2009 Form 10-Ks to understand what type of references are actually being used in practice. All financial statements reviewed were for those entities having a fiscal year-end between December 1, 2009, and January 31, 2010, when the FASB codification was fully effective for all of these entities. The entities selected comprised the following:

- Fourteen large accelerated filers (28 percent of the sample)
- Twenty accelerated filers (40 percent of the sample)
- Seven nonaccelerated filers (14 percent of the sample)
- Nine smaller reporting companies (18 percent of the sample)

.116 Of all the entities selected, 50 percent had gone to mostly plain English references in their annual financial statements. However, among these entities, in the "Summary of Significant Accounting Policies" section of the financial statements, many entities did still use specific references to either old FASB standards (pre-FASB Statement No. 168 standards or legacy standards) or specific Accounting Standards Updates (ASUs), when appropriate. There did not seem to be much of a difference in this percentage among large accelerated filers, accelerated filers, and nonaccelerated filers. However, smaller reporting companies were less likely to use plain English (only 33 percent used plain English references).

.117 As for the remaining 50 percent of filers selected, they chose to use either FASB ASC-specific references (36 percent) or to do some sort of dual references (12 percent) between the precodification standards and new FASB ASC guidance. One entity continued to use the old FASB references and did not mention FASB ASC in its financial statements.

.118 For those entities using FASB ASC references, most only referenced to the topic level and did not go down to the subtopic or section level. For those using dual references, in most cases, the new FASB ASC topic was listed first, with the historical FASB reference noted parenthetically. See the following table for a full breakout of the results:

	Plain English References	*FASB ASC References*	*Dual References*	*Old FASB References*
Large Accelerated Filers	7	4	2	1
Accelerated Filers	12	6	2	0
Nonaccelerated Filers	3	3	1	0
Smaller Reporting Companies	3	5	1	0
Total Sample	25	18	6	1

.119 The sampling results make it clear that although both FASB and the SEC have stated that the use of plain English is most appropriate when dealing with financial statements and notes to financial statements, not everyone is there yet. It will be interesting to see if the plain English references trend continues upward once entities have had another full year to get used to FASB ASC. In addition, all new guidance issued in 2010 was issued through ASUs, and there were no legacy standards issued. Therefore, we would expect that in 2010 filings, even the "Summary of Significant Accounting Policies" section of financial statements would no longer refer to any legacy standards.

.120 We found that with the plain English references, some entities chose instead to say something like, "in accordance with the purchase method of accounting and as updated with FASB's April 2009 additional authoritative guidance for business combinations, we ...." Here the entity uses plain English but also makes it clear which new guidance they are following. This would be most important for those FASB changes with early adoption provisions to make it clear which method an entity used.

.121 FASB has stated that ASUs do not carry any authority. It is the updates that are made to the codification once the ASU is effective that are authoritative. Therefore, entities would be wise to ensure that when they are referring to authoritative literature, use of either plain English or the FASB ASC references would be appropriate, rather than just naming the ASU that brought about the change in accounting.

.122 In addition, entities would want to be sure that they do not refer to any legacy standards in their 2010 financial statements. Because all changes made to the codification in 2010 were through ASUs, referring to legacy standards is no longer correct. For example, since the codification became effective, there have been several updates to the *Fair Value Measurements and Disclosures* topic. Therefore, referring to FASB Statement No. 157, *Fair Value Measurements*, is no longer accurate because this standard does not incorporate changes made since the codification became effective in 2009. We would expect that entities that used dual references

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to both the legacy standards and FASB ASC references would not continue to use those dual references in 2010 financial statements.

.123 Many entities also have a section of their notes to financial statements titled "Effect of Accounting Pronouncements Not Yet Adopted." In 2010, we would expect the title of this section to change to something like "Effect of Authoritative Accounting Guidance Not Yet Adopted."

.124 It will be interesting to see if both public and nonpublic entities make any additional refinements or changes to their 2010 financial statements as we move into our first full year with FASB ASC. It is our understanding that the SEC may be issuing comment letters to those entities that are not properly reflecting the current state of U.S. GAAP in their financial statements, whether that be by using plain English or using the new FASB ASC references.

Accounting for Costs Associated With Acquiring or Renewing Insurance Contracts

.125 In October 2010, FASB issued ASU No. 2010-26, *Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts*. The objective of this update is to address diversity in practice regarding the interpretation of which costs relating to the acquisition of new or renewal insurance contracts qualify for deferral.

.126 This ASU specifies that the following costs incurred in the acquisition of new and renewal contracts should be capitalized in accordance with the amendments in this ASU:

1. Incremental direct costs of contract acquisition. Incremental direct costs are those costs that result directly from and are essential to the contract transaction(s) and would not have been incurred by the insurance entity had the contract transaction(s) not occurred.
2. Certain costs related directly to the following acquisition activities performed by the insurer for the contract:
   a. Underwriting
   b. Policy issuance and processing
   c. Medical and inspection
   d. Sales force contract selling.

.127 The costs related directly to those activities include only the portion of an employee's total compensation (excluding any compensation that is capitalized as incremental direct costs of contract acquisition) and payroll-related fringe benefits related directly to time spent performing those activities for actual acquired contracts and other costs related directly to those activities that would not have been incurred if the contract had not been acquired.

.128 Advertising costs should be included in deferred acquisition costs only if the capitalization criteria in the direct-response advertising guidance in FASB ASC 340-20 are met. If those criteria are met, the direct-response advertising costs should then be included as deferred acquisition costs for classification, subsequent measurement, and premium deficiency purposes in accordance with FASB ASC 944, *Financial Services—Insurance*. If the capitalization criteria in FASB ASC 340-20 are not met, advertising costs are not included as deferred acquisition costs and should be accounted for in accordance with the guidance in FASB ASC 720-35.

.129 All other acquisition-related costs—including costs incurred by the insurer for soliciting potential customers, market research, training, administration, unsuccessful acquisition or renewal efforts, and product development—should be charged to expense as incurred. Administrative costs, rent, depreciation, occupancy, equipment, and all other general overhead costs are considered indirect costs and should be charged to expense as incurred.

.130 If the initial application of the amendments in this ASU results in the capitalization of acquisition costs that had not been capitalized previously by an entity, the entity may elect not to capitalize those types of costs.

.131 The amendments in this ASU do not affect the guidance in paragraphs 4–5 of FASB ASC 944-30-25, which prohibits the capitalization of certain costs incurred in obtaining universal life-type contracts.

.132 The amendments in this ASU modify the definition of the types of costs incurred by insurance entities that can be capitalized in the acquisition of new and renewal contracts. This revised definition may represent a significant change in practice for many insurance entities. For example, many insurance entities capitalize costs relating to unsuccessful contract acquisitions. The amendments in this ASU specify that the costs must be based on successful efforts (that is, acquiring a new or renewal contract). The amendments also specify that advertising costs only should be included as deferred acquisition costs if the direct-response advertising criteria in FASB ASC 340-20 are met.

.133 The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2011. The amendments in this ASU should be applied prospectively upon adoption. Retrospective application to all prior periods presented upon the date of adoption also is permitted, but not required. Early adoption is permitted, but only at the beginning of an entity's annual reporting period.

Investments Held Through Separate Accounts—Consolidation

.134 In April 2010, FASB issued ASU No. 2010-15, *Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments*. This ASU addresses practice questions on how investments held through the separate accounts of an insurance entity affect the consolidation analysis under FASB ASC 810-10.

.135 This ASU clarifies that, for separate account arrangements meeting the criteria in FASB ASC 944-80-25-2, an insurance entity should not consider any separate account interests held for the benefit of policy holders in an investment to be the insurer's interests and should not combine those interests with its general account interest in the same investment when assessing the investment for consolidation, unless the separate account interests are held for the benefit of a related party policy holder as defined in the variable interest subsections of FASB ASC 810-10 and those subsections require the consideration of related parties.

.136 This ASU provides amendments to FASB ASC 944-80 to clarify that for the purpose of evaluating whether the retention of specialized accounting for investments in consolidation is appropriate, a separate account arrangement meeting the criteria in FASB ASC 944-80-25-2 should be considered a subsidiary. Additionally, this ASU does not require an insurer to consolidate an investment in which a separate account holds a controlling financial interest if the investment is not or would not be consolidated in the standalone financial statements of the separate account. This ASU also provides guidance on how an insurer should consolidate an investment fund in situations in which the insurer concludes that consolidation is required.

.137 The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2010. Early adoption is permitted. The amendments in this ASU should be applied retrospectively to all prior periods upon the date of adoption.

Decreases in Ownership of a Subsidiary

.138 In January 2010, FASB issued ASU No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*. This ASU addresses implementation issues related to the changes in ownership provisions in FASB ASC 810-10 (issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*). These amendments clarify that the scope of the decrease in ownership provisions of FASB ASC 810-10 and related guidance applies to a subsidiary or group of assets that is a business or nonprofit activity, a subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture, and an exchange of a group of assets that constitutes a business or nonprofit activity for a noncontrolling interest in an entity (including an equity method investee or joint venture). Further, the amendments clarify that the decrease in ownership guidance

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in FASB ASC 810-10 does not apply to the following transactions, even if they involve businesses: sales of in-substance real estate and conveyances of oil and gas mineral rights. The amendment also expands the required disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of FASB ASC 810-10. This ASU is effective beginning in the period that an entity adopts FASB Statement No. 160. If an entity has already adopted this guidance, then the amendments in this ASU are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this ASU should be applied retrospectively to the first period that an entity adopted FASB Statement No. 160.

Accounting for Uncertainty in Income Taxes

.139 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities, and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.
- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FASB ASC 740-10-50-15[a]–[b]).

.140 For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009.

Consolidation of Variable Interest Entities

.141 For calendar year entities, 2010 is the first year of application of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB Statement No. 167 was incorporated into FASB ASC through ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited.

.142 The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly affect the entity's economic performance. This statement also amends consolidation of variable interest entities (VIEs) guidance to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

.143 Entities will be required to provide additional disclosures about involvement with VIEs and any significant changes in risk exposure due to that involvement. Entities also will be required to disclose how involvement with a VIE affects the entity's financial statements.

.144 FASB Statement No. 167 retains the scope of previous VIE consolidation accounting guidance, with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, which was incorporated into FASB ASC by ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*.

.145 This statement also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a VIE or disclose information about its involvement in a VIE, or both
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks associated with an enterprise's involvement with the VIE
- How an enterprise's involvement with the VIE affects the enterprise's financial position, financial performance, and cash flows

Accounting for Transfers of Financial Assets

.146 Calendar year entities must also start applying the provisions of FASB Statement No. 166 in 2010. FASB Statement No. 166, which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, requires more information about transfers of financial assets, including securitization transactions, and those circumstances in which entities have continuing exposure to the risks related to transferred financial assets. FASB Statement No. 166 was incorporated into FASB ASC by ASU No. 2009-16 and is discussed in FASB ASC 860, *Transfers and Servicing*. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. It is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

.147 Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance.

.148 The primary objectives of the disclosure requirements of this guidance are to provide the financial statement users with a clear understanding of the following:

- A transferor's continuing involvement (as defined by the FASB ASC glossary), if any, with transferred financial assets
- The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets

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- How servicing assets and servicing liabilities are reported under this pronouncement
- For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows

.149 These objectives must be met by the disclosures, regardless of the specific requirements of the pronouncement. It may be the case that an entity provides greater detail than what is a required disclosure to meet these objectives, depending on the facts and circumstances.

Subsequent Events

.150 FASB Statement No. 165, *Subsequent Events*, which has been codified in FASB ASC 855, *Subsequent Events*, is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued). The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

.151 In particular, this statement sets forth the following:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

.152 FASB states that this guidance should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. In September 2009, the AICPA issued Technical Questions and Answers (TIS) section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), which notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. This question and answer can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

.153 In February 2010, FASB issued ASU No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, to address questions that arose in practice about potential conflicts between FASB ASC 855 and SEC guidance—specifically, the requirements to disclose the date that the financial statements are issued. This ASU also addresses the intended breadth of the reissuance disclosure provision related to subsequent events.

.154 ASU No. 2010-09 requires an entity that is an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market to evaluate subsequent events through the date the financial statements are issued. All other entities must evaluate subsequent events through the date the financial statements are available to be issued. Further, an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. Lastly, only non-SEC filers should disclose in the revised financial statements the dates through which subsequent events have been evaluated in both the issued or available-to-be-issued financial statements and the revised financial statements. Revised financial statements are considered reissued financial statements.

.155 The amendments in ASU No. 2010-09 are effective upon issuance, except for the use of the issued date for conduit bond obligors. That amendment is effective for interim or annual periods ending after June 15, 2010. In June 2010, the AICPA issued TIS section 8700.03, "Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor" (AICPA, *Technical Practice Aids*), to provide guidance related to the effect of this ASU on the auditor's responsibilities for subsequent events relative to a conduit debt obligor and the date of the auditor's report.

Fair Value

.156 FASB ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity. *Fair value* is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Measuring Liabilities at Fair Value

.157 FASB issued ASU No. 2009-05, *Fair Value Measurements and Disclosures (Topic 820)—Measuring Liabilities at Fair Value*, to increase the consistency in the application of FASB ASC 820 to liabilities because many constituents had expressed concern. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10.

.158 This ASU states that, in circumstances in which a quoted price in an active market for the identical liability is not available, fair value of the liability must be measured by either (*a*) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities, or similar liabilities when traded as assets, or (*b*) another valuation technique that is consistent with the principles of FASB ASC 820, such as an income approach or a market approach. Further, if a restriction on the transference of the liability exists, the ASU clarifies that an entity is not required to factor that in to the inputs of the fair value determination. Lastly, the ASU also clarifies that a quoted price in an active market for the identical liability, or an unadjusted quoted price in an active market for the identical liability, when traded as an asset, are level 1 measurements within the fair value hierarchy. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after its issuance in August 2009. The full text of the ASU can be accessed from FASB's website at www.fasb.org.

Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)

.159 FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both

- does not have a readily determinable fair value. The FASB ASC glossary states that an equity security has a readily determinable fair value if it meets any of the following conditions:
    - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year.
    - The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.

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— The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes are not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies.*

.160 As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the net asset value (NAV) per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

.161 This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

.162 These amendments are effective for interim and annual periods ending after December 15, 2009, and are included in FASB ASC 820-10. An AICPA practice aid, *Alternative Investments—Audit Considerations,* also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments.

.163 In December 2009, the AICPA issued sections .18–.27 of TIS section 2220, *Long-Term Investments* (AICPA, *Technical Practice Aids*), to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers compliment the guidance provided in ASU No. 2009-12.

.164 Topics covered in these questions and answers include:

- The circumstances when NAV may be used to estimate the fair value of investments as a practical expedient
- How to identify the unit of account for interests in alternative investments
- Considerations for determining whether the reported NAV has been calculated in a manner consistent with FASB ASC 946
- Examples of circumstances when an adjustment to the reported NAV may be necessary
- How to adjust the reported NAV when it is not as of the reporting entity's measurement date
- How to adjust the reported NAV when it has not been calculated in accordance with FASB ASC 946
- The determination of the appropriate level within the fair value hierarchy for NAV of alternative investments in relation to the ability to redeem the investment versus the actual redemption request for the investment
- The definition of *near term* for the purposes of determining the appropriate level within the fair value hierarchy
- The tailoring of disclosures categories to address the nature and risks of investments

- Some considerations for determining the fair value of alternative investments when not utilizing NAV as a practical expedient

.165 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurements Disclosures

.166 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers between the three levels and the underlying reasons for such transfers would be useful to financial statements users.

.167 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.168 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.169 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Disclosures About Credit Quality and Allowance for Credit Losses

.170 In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. The ASU amends the existing disclosures to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis:

- A rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method. For each disaggregated ending balance, the related recorded investment in financing receivables should also be disclosed.
- The nonaccrual status of financing receivables by class of financing receivables.
- Impaired financing receivables by class of financing receivables.

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.171 The amendments in this ASU require an entity to provide the following additional disclosures about its financing receivables:

- Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables (see FASB ASC 310-10-55-19 for examples of credit quality indicators)
- The aging of past due financing receivables at the end of the reporting period by class of financing receivables
- The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment

.172 An entity must also describe, by portfolio segment, its accounting policies and methodology used to estimate its allowance for credit losses, including the identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

.173 The amendments in this ASU apply to all entities with financing receivables. Examples of financing receivables include loans; trade receivables; notes receivable; and receivables relating to a lessor's leveraged, direct financing, and sales-type leases. See the "Pending Content" in paragraphs 13–15 of FASB ASC 310-10-55 for more information on the definition of *financing receivable*, including a list of items that are excluded from the definition (for example, debt securities). In addition, the "Pending Content" in paragraphs 7–12 of FASB ASC 310-10-55 illustrates certain disclosures required by this ASU.

.174 For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

Convergence With International Financial Reporting Standards

.175 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and International Financial Reporting Standards (IFRSs) and eliminate the differences between them. In the Norwalk agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

SEC Work Plan for Consideration of IFRSs

.176 In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to the SEC's roadmap on its consideration of global accounting standards, including a confirmation of its continued support for the convergence of U.S. GAAP and IFRSs in order to narrow the differences between the two sets of standards. The SEC believes that a more comprehensive work plan is necessary to transparently lay out the work that must be done to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, time frame, and methodology for any such transition. Therefore, the SEC has

indicated that it will carefully consider and deliberate whether these changes are in the best interest of U.S. investors and markets.

.177 The SEC directed its staff to execute a work plan, the results of which will aid the SEC in its evaluation of the impact that the use of IFRSs by U.S. entities would have on the U.S. securities market. The work plan includes consideration of IFRSs, both as they currently exist and after the completion of the various convergence projects underway by FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received on the roadmap, including the following:

- Sufficient development and application of IFRSs for the U.S. reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRSs
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

.178 Beginning no later than October 2010, and frequently thereafter, the SEC staff will provide public progress reports on the work plan, as well as the status of the FASB and IASB convergence projects, until the work is complete. By 2011, assuming completion of these convergence projects and the staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. Commentors provided feedback on the timing discussed in the roadmap, suggesting that a four or five year time frame would be necessary to successfully implement a change in their financial reporting systems to incorporate IFRSs. Under that assumption, if the SEC determines in 2011 to incorporate IFRSs into the U.S. financial reporting system, the first time that U.S. entities would report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of Release No. 33-9109 and also can be found on the SEC's website at www.sec.gov.

.179 In August 2010, the SEC issued two releases (Release Nos. 33-9133 and 33-9134, *Notice of Solicitation of Public Comment on Consideration of Incorporating IFRS Into the Financial Reporting System for U.S. Issuers*) to solicit public comment on its ongoing consideration of incorporating IFRSs into the financial reporting system for U.S. issuers. The first release contains requests for comment on three topics derived from the work plan that are related to the potential impact on investors. The second release contains requests for comment on three topics, also derived from the work plan, that are related to the potential impact on U.S. issuers. All comments will be available on the SEC's website.

International Financial Reporting Standard for Small and Medium-Sized Entities

.180 The IASB issued *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs*) to be a self-contained global accounting and financial reporting standard applicable to the general purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs. *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability.

.181 The AICPA Governing Council recognizes the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01), gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state. Any remaining barriers may come in the form of unwillingness by a private company's

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financial statement users to accept financial statements prepared under *IFRS for SMEs*, and a private company's expenditure of money, time, and effort to convert to *IFRS for SMEs*.

.182 Information about IFRSs and *IFRS for SMEs* can be found at www.ifrs.com. Additionally, to help its membership, the AICPA has developed an IFRS for SMEs—U.S. GAAP Comparison Wiki. The purpose of the Wiki is to provide a detailed and comprehensive comparison of IFRS for SMEs with corresponding requirements of U.S. GAAP. But it is more than just a comparison resource—it is a wiki. That means it is a collaborative, ongoing work in progress for anyone to contribute to and use. The Wiki is found at http://wiki.ifrs.com/.

.183 Entities interested in *IFRS for SMEs* or possibly adopting the standard may find it helpful to take the following actions:

- *Monitor the efforts of the AICPA/FAF/NASBA "Blue-Ribbon" Panel on Standard Setting for Private Companies*. For more information about the panel, go to www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176156684820.
- *Monitor convergence efforts of FASB and the IASB*.
- *Stay informed on SEC developments*. Public companies will be directly affected by the SEC's decision to adopt IASB standards. The future of private company reporting will also likely be affected by an SEC mandate to adopt IFRSs.
- *Develop a high-level analysis of the potential impact on accounting policies, processes and systems, contracts, legal agreements, and financing and tax structures*.

Private Company Financial Reporting

.184 The AICPA and the Financial Accounting Foundation established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel also is sponsored by the National Association of State Boards of Accountancy. The "blue-ribbon panel" will provide recommendations through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies are needed. The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities taking more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries. The panel's issued report will be made available to the public, and the resulting action plan is expected to be exposed for public comment prior to that plan being finalized. The panel will issue a report containing its recommendations to the Financial Accounting Foundation (FAF) board of trustees in January 2011. The report will be publicly available, and the resulting action plan is expected to be exposed for public comment prior to the plan being finalized.

.185 During the July 2010 meeting of the panel, seven alternative models for private company financial reporting were discussed. Models based on IFRSs and a model that would have resulted in no change to private company financial reporting were eliminated. All remaining models would result in differences in GAAP for private and public entities; the main focus of the panel moving forward will be to select a model that is relevant to users of private company financial reports because this has become the overriding issue. The three primary models the panel agreed to focus on going forward are U.S. GAAP with Exclusions for Private Companies—with enhancements; U.S. GAAP—Baseline GAAP with Public Company Add-Ons; and Separate, Stand-Alone GAAP Based on Current U.S. GAAP. Most of the panel members also expressed their discontent with the current make-up of FASB and its heavy, but appropriate, focus on public companies. This led to another key discussion topic: the structure of whatever model is chosen—the current FASB; a restructured FASB (with greater private company representation); or a new, separate Private Company Standards Board under the oversight of the FAF.

Recent Pronouncements

.186 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.187 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801) Issue Date: December 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 801 to reflect changes in the compliance audit environment and incorporates the risk assessment standards. It requires the auditor to adapt and apply the AU sections of the AICPA's *Professional Standards* to compliance audits and provides guidance on how to do so. It is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.
SAS No. 116, *Interim Financial Information* (AICPA, *Professional Standards*, AU sec. 722) Issue Date: February 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 722 to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to Securities and Exchange Commission (SEC) Rule 144A or participating in private equity exchanges. It is effective for reviews of interim financial information for interim periods beginning after December 15, 2009. Earlier application is permitted.
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.
Interpretation No. 1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, AT sec. 9501 par. .01–.07) Issue Date: September 2010 (Interpretive publication)	For insured depository institutions (IDI) that require an examination of internal controls at the IDI level, this interpretation addresses whether the auditor can meet the integrated audit requirement when an IDI does not prepare financial statements for external distribution and, if so, how the auditor can report on the effectiveness of the IDI's internal control over financial reporting.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 15, *Audit Evidence* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard explains what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.
PCAOB Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards) Issue Date: January 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard and its related amendments supersede the interim concurring partner review requirements and update the interim quality control standards. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB. The standard provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. It is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009.
PCAOB Staff Question and Answer, *Auditing Standard No. 7,* Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10) Issue Date: February 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This staff question and answer provides further implementation guidance on the documentation requirements of Auditing Standard No. 7 in light of comments the SEC received during its comment period.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Staff Audit Practice Alert (PA) No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06) Issue Date: July 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert is intended to remind registered public accounting firms of their obligations when using the work of other firms or using assistants engaged from outside the firm. The alert was prompted by observations by the PCAOB that a number of registered public accounting firms located within the United States have been issuing reports on financial statements filed by issuers that have substantially all of their operations outside of the United States, and some of these firms may not be conducting those audits in accordance with PCAOB standards.
PCAOB Staff Audit PA No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05) Issue Date: April 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert explains that significant unusual transactions, especially those close to period-end that pose difficult substance over form questions, can provide opportunities for entities to engage in fraudulent financial reporting. This staff audit practice alert is designed to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions.

Recent ASUs

.188 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19 *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) ***Accounting Standards Codification*** **(ASC)**	
Accounting Standards Update (ASU) No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
Liabilities Area of FASB ASC	
ASU No. 2009-15 (October 2009)	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*

(continued)

Recent Accounting Standards Updates	
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2009-13 (October 2009)	*Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
Broad Transactions Area of FASB ASC	
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2009-17 (December 2009)	*Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2009-12 (September 2009)	*Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*
ASU No. 2009-16 (December 2009)	*Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-03 (January 2010)	*Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*

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Recent Accounting Standards Updates	
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-24 (August 2010)	*Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-23 (August 2010)	*Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-07 (January 2010)	*Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*
ASU No. 2009-14 (October 2009)	*Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*

Recently Issued Technical Questions and Answers

.189 The following table presents a list of nonauthoritative accounting and audit and attest TIS sections recently issued by the AICPA. Recently issued TIS sections can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Recently Issued Technical Questions and Answers (AICPA, Technical Practice Aids)	
Accounting	
Technical Questions and Answers (TIS) section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"

(continued)

Recently Issued Technical Questions and Answers (AICPA, Technical Practice Aids)

TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments"
TIS section 6910.33 (December 2009)	"Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination"
TIS section 2220.27 (December 2009)	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
TIS section 2220.26 (December 2009)	"Categorization of Investments for Disclosure Purposes"
TIS section 2220.25 (December 2009)	"Impact of 'Near Term' on Classification Within Fair Value Hierarchy"
TIS section 2220.24 (December 2009)	"Disclosures—Ability to Redeem Versus Actual Redemption Request"
TIS section 2220.23 (December 2009)	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
TIS section 2220.22 (December 2009)	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"
TIS section 2220.21 (December 2009)	"Determining Whether an Adjustment to NAV Is Necessary"
TIS section 2220.20 (December 2009)	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, *Financial Services—Investment Companies*"
TIS section 2220.19 (December 2009)	"Unit of Account"

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Recently Issued Technical Questions and Answers (AICPA, Technical Practice Aids)	
TIS section 2220.18 (December 2009)	"Applicability of Practical Expedient"
TIS section 6910.32 (July 2009)	"Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt"
TIS section 6910.31 (July 2009)	"The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the '5 Percent Test' Described in TIS Section 6910.30"
TIS section 6910.30 (July 2009)	"Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets"
TIS section 1600.04 (June 2009)	"Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements"
TIS section 1500.07 (June 2009)	"Disclosure Concerning Subsequent Events in OCBOA Financial Statements"
Audit and Attest	
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"
TIS section 8700.02 (September 2009)	"Auditor Responsibilities for Subsequent Events"
TIS section 8700.01 (September 2009)	"Effect of FASB ASC 855 on Accounting Guidance in AU Section 560"

Recent AICPA Independence and Ethics Developments

.190 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.191 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3, "Performance of Nonattest Services" under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05). Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. The PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as "maintaining internal control" for the client.

.192 To address the possible inconsistency in Interpretation No. 101-3, the PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members better distinguish between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

.193 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

.194 Exposure drafts issued by the PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

On the Horizon

.195 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the insurance industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.196 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Standard Setting Body	*Website*
AICPA Auditing Standards Board	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AuditingStandardsBoard/Pages/ASB.aspx
Financial Accounting Standards Board	www.fasb.org
Governmental Accounting Standards Board	www.gasb.org
Professional Ethics Executive Committee	www.aicpa.org/InterestAreas/ProfessionalEthics/Community/Pages/community.aspx
Public Company Accounting Oversight Board	www.pcaob.org
Securities and Exchange Commission	www.sec.gov

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Overhaul Project—AICPA Audit and Accounting Guide *Property and Liability Insurance Entities*

.197 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Property and Liability Insurance Entities*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1990. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.198 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the ISAs issued by the IAASB. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the first half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU sections 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

.199 In May 2010, the expected effective date of the clarified standards was revised to be applicable to be for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Interim Financial Information

.200 In July 2010, the ASB issued two proposed SASs on interim financial information. The first, *Revised Applicability of Statement on Auditing Standards No. 116*, Interim Financial Information, is intended to revise paragraph 5 of SAS No. 116, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), so that the guidance in SAS No. 116 would be applicable when the auditor audited the entity's latest annual financial statements and the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. Currently, the guidance in SAS No. 116 is applicable when the auditor performs the audit of the latest annual financial statements and expects to be engaged to audit the current year financial statements (and, therefore, is not applicable when the auditor expects that a new auditor may be engaged for the current year). This proposed amendment would be effective for interim reviews of interim financial information for periods beginning after December 15, 2011, with early implementation permitted. Comments are due by October 8, 2010.

.201 The second proposal on interim financial information, *Interim Financial Information* (Redrafted), would supersede SAS No. 116 and represents the redrafting of the guidance to apply clarity drafting conventions. The main changes to existing standards are as follows:

- Replacement of the term *accountant* with auditor
- The change to paragraph 5 discussed in the prior paragraph
- Requirement of the auditor to issue a written report unless the review of the interim financial information is required by a third party and the third party does not require a written review report
- Allowance of oral reports for entities that are subject to external requirements to report in a manner that is substantially similar to the reporting required of issuers, pursuant to PCAOB standards
- Requirement for the auditor to perform procedures consistent with those required for acceptance of an engagement to audit financial statements
- Requirement for the review report to include a statement that the review of interim financial information was conducted in accordance with auditing standards generally accepted in the United States of America

.202 This proposed SAS would be effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2012. Comments for this proposed SAS are also due by October 8, 2010.

Exposure Drafts on Auditor's Reports

.203 The ASB issued three proposed SASs related to auditor's reports: *Forming an Opinion and Reporting on Financial Statements*, *Modifications to the Opinion in the Independent Auditor's Report*, and *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. These proposed standards are drafted with the ASB's clarity drafting conventions and are intended to converge with ISAs. The intent of issuing three separate SASs is to assist practitioners in identifying and applying the reporting requirements and guidance. The ASB has made various changes to the related ISAs to tailor them to the United States; however these changes have not been substantial in nature.

.204 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Exposure Drafts on Special Considerations Audits

.205 Another exposure draft issued by the ASB contains two proposed SASs: *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* and *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. These proposed standards have been drafted with the clarity drafting conventions and are intended to converge with the equivalent ISAs. No meaningful differences exist between these proposed standards and the ISAs. *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* addresses the application of GAAS to financial statements prepared under the cash, tax, regulatory, or contractual bases of accounting. It also replaces the term *other comprehensive basis of accounting* with *special purpose framework*.

.206 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* introduces new planning, performance, and reporting requirements for these engagements. The proposed SAS also clarifies that a single financial statement and a specific element of a financial statement include the related notes.

.207 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

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Auditing and Attestation Pipeline—Issuers

Confirmations

.208 The PCAOB has proposed a draft of an auditing standard on confirmations. A concept release was originally issued in April 2009 and received 24 comment letters. This proposed auditing standard, issued in July 2010, would strengthen the requirements under the current auditing standard, AU section 330, *The Confirmation Process* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and replace it, upon final issuance of a standard and approval from the SEC. The proposed new standard

- requires confirmation procedures for specific accounts, such as receivables that arise from credit sales, loans, or other transactions, and also in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.
- incorporates procedures in response to the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating nonresponses to confirmation requests.
- updates the confirmation guidance to reflect significant advances in technology and explains that confirmation responses received electronically (for example, by fax e-mail, through an intermediary, or direct access) might involve additional risks relating to reliability. Therefore, the auditor must perform additional requirements.
- defines a confirmation response to include electronic or other medium.
- enhances requirements when confirmation responses include disclaimers and restrictive language by requiring the auditor to evaluate the effect on the reliability of a confirmation response. Further, if the disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

.209 In drafting this proposed standard, the PCAOB considered the guidance contained in ISA 505, *External Confirmations*, and the AICPA's proposed guidance on confirmations. This standard is anticipated to be effective for auditors for fiscal years ending on or after December 15, 2011.

Communications With Audit Committees

.210 In March 2010, the PCAOB proposed for comment an auditing standard on *Communications with Audit Committees* and a series of related amendments to its interim standards that are intended to (*a*) enhance the relevance and effectiveness of the communications between the auditor and the audit committee and (*b*) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. Two of the new requirements would be for the auditor (*a*) to establish a mutual understanding of the terms of the audit engagement with the audit committee and to document that understanding in the engagement letter and (*b*) to evaluate the adequacy of two-way communication between the auditor and audit committee. Additionally, the proposal also includes requirements for the auditor to communicate with the audit committee regarding the following:

- An overview of the audit strategy and timing of the audit, including a discussion of significant risks; the use of the internal audit function; and the roles, responsibilities, and location of firms participating in the audit
- Critical accounting policies, practices, and estimates
- The auditor's evaluation of the entity's ability to continue as a going concern

.211 The proposed standard would become effective, subject to SEC approval, for audits of fiscal years beginning after December 15, 2010.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.212 The year 2010 has been a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Balance sheet netting
- Statement of comprehensive income
- Discontinued operations

.213 A progress report for the quarter ended March 31, 2010, highlighted the following topics: (*a*) on the financial instruments and insurance contracts topics, the boards have reached different conclusions on significant technical issues that may affect the project timetables of these topics and (*b*) the boards agreed to explore an alternative approach to lessor accounting that may affect the project timetable of this topic. FASB and the IASB also have several other joint projects in process, including balance sheet—offsetting, emissions trading schemes, and reporting discontinued operations. In March 2010, the exposure draft *Conceptual Framework for Financial Reporting* was published for public comment. In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. Specifically, the boards were scheduled to expose for comment numerous major exposure drafts during the second quarter of 2010, and stakeholders voiced concern about their ability under those circumstances to provide high-quality input. The boards have developed a modified strategy to accommodate these concerns by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate consultation document seeking stakeholder input about effective dates and transition methods.

.214 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. The boards also decided to issue separate exposure drafts to address differences in the two sets of standards on balance sheet netting of derivative contracts and other financial instruments. The IASB has also made its projects on improved disclosures about derecognized assets and other off balance sheet risks, consolidations, and insurance contracts priorities. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, have been extended into the second half of 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively affect the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the U.S. financial system.

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.215 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Insurance Contracts

.216 In July 2010, IASB issued an exposure draft, *Insurance Contracts*. This is the continuation of phase II of IASB's insurance contracts project, which will provide a basis for consistent accounting for insurance contracts on the longer term.

.217 In September 2010, FASB issued a discussion paper, *Preliminary Views on Insurance Contracts*, to solicit broad-based input on how to improve, simplify, and converge the financial reporting requirements for insurance contracts.

IASB Exposure Draft

Scope

.218 IASB's exposure draft applies to all insurance contracts that an entity issues and reinsurance contracts that it holds. The exposure draft also covers financial instruments that contain a discretionary participation feature.

Recognition

.219 IASB's exposure draft requires an entity to recognize an insurance contract asset or insurance contract liability when it becomes party to the insurance contract. An insurer becomes a party to an insurance contract on the earlier of the following two dates:

- When the insurer is bound by the terms of the insurance contract, and
- When the insurer is first exposed to risk under the contract, which is when the insurer can no longer withdraw from its obligation to provide insurance coverage to the policyholder for insured events and no longer has the right to reassess the risk of the particular policyholder and, as a result, cannot set a price that fully reflects that risk.

Measurement

.220 IASB's exposure draft proposes a comprehensive measurement approach for all types of insurance contracts issued by entities, and reinsurance contracts held by entities, with a modified approach for some short-duration contracts. The approach is based on the principle that insurance contracts create a bundle of rights and obligations that work together to generate a package of cash inflows (premiums) and outflows (benefits and claims).

.221 Under IASB's exposure draft, an insurer would apply to the package of cash flows a measurement approach that uses the following building blocks:

1. A current estimate of the future cash flows (explicit, unbiased, probability-weighted cash flows of the future cash outflows less the future cash inflows)
2. A discount rate that adjusts those cash flows for the time value of money
3. An explicit risk adjustment
4. A residual margin

.222 The risk adjustment represents the maximum amount that an insurer would rationally pay to be relieved of the risk that the ultimate fulfillment cash flows exceed those expected. It is remeasured at the end of each reporting period and declines over time as the insurer is released from risk. IASB's exposure draft includes application guidance that discusses the techniques for estimating the risk adjustment and limits the allowable techniques to three approaches.

.223 The residual margin is calibrated at inception to an amount that means the insurer recognizes no gain on entering into an insurance contract. If the initial measurement of an insurance contract results in a day one loss, then the insurer should recognize that day one loss. The residual margin is released over the coverage period in a systematic manner based on the passage of time, unless the pattern of claims and benefits makes another pattern more appropriate.

.224 Incremental acquisition costs (costs of selling, underwriting, and initiating a contract that would not have been incurred if the insurer had not issued that particular contract) on successful contract sales are to be included in the present value of the fulfillment cash flows. All other acquisition costs should be expensed when incurred.

.225 FASB's tentative conclusions on the measurement model differ from IASB's exposure draft in that instead of having a separate risk adjustment and residual margin, FASB's model would reflect risk and uncertainty implicitly through a single composite margin. The composite margin is measured at inception to eliminate any day one gains. The composite margin is not remeasured, but it is released over the coverage period and the benefit paying period.

Measurement—Short-Duration Contracts

.226 Under IASB's exposure draft, for most short-duration contracts (with coverage period of one year or less), a modified version of the measurement approach would apply for preclaim liabilities.

.227 An insurer would measure its preclaim obligation at initial recognition as

1. the premium, received at initial recognition, plus the expected present value of future premiums, less
2. the incremental acquisition costs.

.228 The insurer would subsequently reduce the preclaims obligation over the coverage period in a way that best reflects the exposure from providing coverage (on the basis of the passage of time but on the basis of expected timing of incurred claims and benefits, if that pattern differs significantly from the passage of time).

.229 The preclaim liability is the preclaim obligation less the expected present value of future premiums. Liabilities for claims incurred (after the preclaim period) are measured at the present value of fulfillment cash flows under the general measurement model.

Unbundling

.230 Some insurance contracts contain one or more components that would be within the scope of another standard if the insurer accounted for those components as separate contracts. IASB's exposure draft requires that if the component is not closely related to the insurance coverage specified in the contract, an insurer should account for that component as if it were a separate contract (referred to as unbundling).

Presentation

.231 IASB's exposure draft proposes that an insurer present each portfolio of insurance contracts as a single item within insurance contract assets or insurance contract liabilities. An insurer should also present the pool of assets underlying unit-linked contracts as a single line item, not commingled with the insurer's other assets.

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.232 IASB's exposure draft proposes a new presentation for the statement of comprehensive income. An insurer should not present premiums, claims expenses, claims handling expenses, incremental acquisition costs, and other expenses included in the measurement of the insurance contract in the statement of comprehensive income. These items will instead be treated as deposit receipts and repayment of deposits. The insurer should include insurance contract line items in its statement of comprehensive income for the following amounts:

- Underwriting margin—disaggregated either in the statement of comprehensive income or in the notes into
  - the change in risk adjustment and
  - the release of residual margin.
- Gains and losses at initial recognition—disaggregated either in the statement of comprehensive income or in the notes into
  - losses on insurance contracts acquired in a portfolio transfer.
  - gains on reinsurance contracts bought by a cedant.
  - losses at initial recognition of an insurance contract.
- Acquisition costs that are not incremental at the level of an individual contract.
- Experience adjustments and changes in estimates—disaggregated either in the statement of comprehensive income or in the notes into
  - experience adjustments.
  - changes in estimates of cash flows and discount rates.
  - impairment losses on reinsurance assets.
- Interest on insurance contract liabilities.

.233 For short-duration contracts under the modified measurement model for preclaims liability, an insurer should include in its statement of comprehensive income line items that present the following amounts from insurance contracts for the period:

- The underwriting margin, disaggregated either in the statement of comprehensive income or in the notes into
  - premium revenue, determined as the gross release of the preclaims obligation (that is, grossed-up for the amortization of incremental acquisition costs).
  - claims incurred.
  - expenses incurred.
  - amortization of incremental acquisition costs included in the preclaims obligation.
- Changes in additional liabilities for onerous contracts.

Transition

.234 Under IASB's exposure draft, at the beginning of the earliest period presented, with a corresponding adjustment to retained earnings, an insurer should

- measure each portfolio of insurance contracts at the present value of the fulfillment cash flows. For insurance contracts to which these transitional provisions are applied, the measurement, both at transition and subsequently, does not include a residual margin.
- derecognize any existing balances of deferred acquisition costs.

- derecognize any intangible assets arising from insurance contracts assumed in previously recognized business combinations. That adjustment does not affect intangible assets, such as customer relationships and customer lists, which relate to possible future contracts.

.235 IASB's exposure draft does not include a proposed effective date. Instead, the effective date will be considered when the boards meet to discuss the effective dates for all of the major joint projects currently underway and expected to be completed in 2011.

FASB Discussion Paper

.236 The solicited feedback in the FASB discussion paper is focused on (*a*) whether the IASB's proposal would be a sufficient improvement to U.S. GAAP to justify the cost of change; (*b*) whether the project goals of improvement, convergence, and simplification would be more effectively achieved by making targeted improvements to existing U.S. GAAP (rather than issuing comprehensive new guidance); and (*c*) certain critical accounting issues for which the preliminary views of FASB differ from the IASB's exposure draft. It is important to remember that although the project on insurance contracts is a joint project, it is not part of the boards' MoU.

The discussion paper summarizes the key aspects of the IASB's exposure draft and compares the proposed changes with both the alternative preliminary views of FASB and the current guidance in FASB ASC 944. FASB decided to issue a discussion paper rather than an exposure draft because of the following reasons:

- The extent of FASB's and the IASB's current accounting guidance for insurance contracts varies significantly; U.S. GAAP comprehensively addresses accounting for insurance contracts by insurance entities, whereas IFRSs do not have comprehensive guidance. Further, the boards have not explicitly evaluated whether the model proposed in the IASB's exposure draft would represent an improvement to U.S. GAAP.
- FASB has not determined whether one model or two models would result in more useful information about insurance contracts. FASB would like additional input from stakeholders on whether different types of insurance contracts warrant different recognition, measurement, and presentation and, if so, what criteria should be used for determining which, if any, types of insurance contracts would use each model.
- FASB is considering whether employer-provided health insurance should be included within the scope of the insurance contracts project and how the recent U.S. health care reform may affect the application of the different approaches.

.237 The discussion paper also includes a listing of common elements of U.S. GAAP on insurance contracts that some stakeholders note could be improved. The appendix of the discussion paper compares the main areas of current U.S. GAAP for insurance contracts, the IASB's proposed approach, and FASB's preliminary views that differ from the proposed approach included in the IASB's exposure draft. Additionally, FASB and the IASB plan to host a series of public roundtable meetings in December 2010 to hear stakeholders' views. Readers should be on alert for developments on this topic.

Comment Deadlines

.238 Comments on the exposure draft are due by November 30, 2010. Comments on FASB's discussion paper are due December 15, 2010, but requested by November 30, 2010, for those who wish to be included as a participant in a FASB roundtable discussion.

Comprehensive Income Exposure Draft

.239 In May 2010, FASB issued a proposed ASU on comprehensive income that would require an entity to report total comprehensive income in a continuous financial statement in two parts: net income and other comprehensive income. In that financial statement, the components of net income and the components of

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other comprehensive income should be displayed. The proposed ASU is intended to simplify how comprehensive income is reported by eliminating two options for how items of comprehensive income are displayed. The proposed ASU contains illustrative examples of the revised financial statement. This proposed ASU is the result of a joint project as part of IFRSs and U.S. GAAP convergence, and the IASB has separately issued a similar document. The proposed amendments would be applied on a fully retrospective basis to improve comparability between reporting periods. Further, because compliance with the proposed amendments is already permitted, early adoption would be permitted. FASB plans to align the effective date with the effective date of the amendments in the proposed ASU on financial instruments. The IASB and FASB aim to finalize an improved and converged standard on other comprehensive income in the fourth quarter of 2010.

Financial Instruments Exposure Draft

.240 Also, in May 2010, FASB issued a proposed ASU on accounting for financial instruments, derivative instruments, and hedging activities. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments; removes the threshold for recognizing credit impairments, creating a single credit impairment model for both loans and debt securities; and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.
- Changes in fair value of equity securities, certain hybrid instruments, and financial instruments that can be prepaid in such a way that the holder would not recover substantially all of its investment would be recognized in net income each reporting period regardless of an entity's business strategy for those financial instruments.
- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, a reconciliation from amortized cost to fair value would be required on the statement of position; with the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period. Therefore, net income will remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period.
- The existing probable threshold for recognizing impairments on loans would be removed. (Currently, FASB ASC 310-10-35-4 states that the concept in U.S. GAAP is that impairment of receivables [including loans] should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. Probable is defined by FASB ASC 310-10-20 as when the future event or events are likely to occur.)
- For changes in the value of financial instruments measured through other comprehensive income, an entity is required to determine if a credit impairment is appropriate at the end of each reporting period based on information related to past events and existing economic conditions. An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts the entity does not expect to collect.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected, which would better reflect a financial instrument's interest yield.

- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.
- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.241 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments). This proposed ASU was not issued jointly with the IASB and does not contain converged guidance; however, the goal still remains for both boards to issue comprehensive improvements to foster international comparability of financial information about financial instruments. The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009. The IASB also issued two exposure drafts on amortized cost and impairment and fair value option for financial liabilities in late 2009 and mid-2010, respectively; the third topic, hedge accounting, is still being deliberated by the IASB, and an exposure draft is expected in the near term. The boards have stated that they will consider together the comment letters and other feedback received on each boards' exposure drafts in an effort to reconcile their differences in ways that foster improvement and convergence.

.242 The effective date of these amendments will be established upon issuance of the final ASU, which is expected in the second quarter of 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional 4 years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

.243 FASB has issued frequently asked questions for the proposed ASU to clarify the proposal by answering common questions received about the proposed guidance. This document can be accessed at www.fasb.org/cs/ContentServer?c=Document_C&pagename= FASB%2FDocument_C%2FDocumentPage&cid=1176157295447.

Revenue Recognition Exposure Draft

.244 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from Contracts with Customers*, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.245 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities

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(for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (*performance obligation* is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).
- determine the transaction price (*transaction price* is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.246 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*) recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

.247 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the boards plan to invite additional comment through a separate consultation on how best to transition over to the new standards. Therefore, no expected specific effective date is stated at this point. Comments on the exposure draft are due on October 22, 2010. This topic is considered by many to be the most pervasive of any FASB has ever worked on. The reader is encouraged to review the exposure draft, consider if it is operational to you or your clients' common revenue transactions, and share any resulting concerns with FASB. The boards also anticipate holding public roundtable meetings after the end of the comment period.

Fair Value Exposure Draft

.248 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.249 The first two of these significant amendments are intended to clarify the application of existing fair value measurement guidance. The past three of these significant amendments would change a particular principle of fair value guidance.

.250 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines highest and best use as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values do not depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.251 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

.252 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to interest rate risk, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice. However, they might affect the current practice for reporting entities that apply the in-use valuation premise more broadly.

.253 The proposed amendments regarding the application of blockage factors and other premiums and discounts in fair value measurements would make two changes to current guidance. Currently, under U.S. GAAP, use of a blockage factor in fair value measurements is only prohibited when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). This would be level 1 within the fair value hierarchy. The first change from the proposed amendments is that a blockage factor is not relevant and, therefore, also should not be used when fair value is measured using a valuation technique that does not use a quoted price. This would be level 2 or level 3 within the fair value hierarchy. Second, the amendments specify that fair value measurements categorized within level 2 and level 3 take into account other premiums and discounts when market participants would consider those premiums or discounts when pricing an asset or a liability, consistent with the unit of account for that asset or liability. Examples include a control premium or a noncontrolling interest discount. These proposed amendments may affect current practice for any reporting entities applying a blockage factor in fair value measurements that is measured using quoted prices and categorized within level 2 of the fair value hierarchy.

.254 Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

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- The effect on a fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances
- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use
- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

.255 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. A final ASU is expected to be issued in the first quarter of 2011.

Financial Statement Presentation Staff Draft

.256 FASB and the IASB are working together to establish a common standard that would improve how information is organized and presented in financial statements. This common standard is intended to address users' concerns that existing requirements permit too many alternative types of presentation and that information in financial statements is highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between an entity's financial statements and its financial results. In 2008, a discussion paper was issued by the boards that outlined the proposed principles for presenting financial statements in a way that portrays a cohesive financial picture of an entity.

.257 Given the magnitude of this project, the expected implementation costs, and the substantial effects it will have on financial statement presentation for many years to come, the boards decided in May 2010 to modify the strategy for this project. Before finalizing an exposure draft, the boards decided to engage in additional outreach activities that focus on the perceived benefits and costs of the proposals and the implications of the proposals for financial reporting by financial service entities. The boards plan on discussing these two areas of focus with preparers and users of financial statements. This outreach will be based on a rough draft of a proposed standard, known as a *staff draft*, and reflects the cumulative tentative decisions made by the boards, concluding with their joint meeting in April 2010. This staff draft was made publicly available solely for this purpose.

.258 The proposals in this project would be applicable to all entities, except a benefit plan within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*; 962, *Plan Accounting—Defined Contribution Pension Plans*; and 965, *Plan Accounting—Health and Welfare Benefit Plans* or IAS 26, *Accounting and Reporting by Retirement Benefit Plans*. The two core financial statement principles in this proposal are cohesiveness and disaggregation. A common structure for the statements of financial position, comprehensive income, and cash flows would be established in the form of required sections, categories or subcategory, and related subtotals. Some proposed specific changes in the classification and format of financial statements include the following:

- Related information would be displayed in the same sections, categories, and subcategory in each statement so that information is more easily associated.
- Presentation of business and financing activities would be separated as follows:
  - The business section would include items that are part of an entity's daily operations and other income generating activities.
  - The financing section would include items that are part of an entity's activities to obtain (or repay) capital.
- Discontinued operations and income taxes would be presented in their own separate sections.

- The statement of changes in equity would not include the sections and categories used in the other statements because that statement presents information solely about changes in items classified in the equity category in the statement of financial position.

.259 Further, FASB plans to propose some changes that are already required by IAS 1, *Presentation of Financial Statements*. The proposal would define and provide the requirements for a complete set of financial statements. Currently, a complete set of financial statements for the period is defined only in the FASB Concepts Statements. An entity would also be required to present one period of comparative information. A *complete set of financial statements* would consist of, at a minimum, statements of financial position, comprehensive income, cash flows and changes in equity, and notes to financial statements for two periods (the current period and the previous period). Also, an opening statement of financial position would be part of a complete set of financial statements if an entity applies an accounting principle retrospectively, restates its financial statements, or reclassifies items in the financial statements.

.260 The boards' tentative decisions on financial statement presentations differ in a few ways in relation to minimum line requirements for the statement of financial position, segment reporting, and net debt presentation. Of these three, the differing stance on segment reporting is the only significant difference. The boards now aim to issue an exposure draft in the first quarter of 2011 and a final improved and converged standard in the fourth quarter of 2011. Both the introduction to the staff draft and the staff draft can be accessed from FASB's website at www.fasb.org.

Leases Exposure Draft

.261 During the third quarter of 2010, the IASB and FASB published for public comment joint proposals to improve the financial reporting of lease contracts. These proposals would result in a consistent approach to lease accounting for both lessees and lessors—a "right of use" approach. This would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, therefore providing more complete and useful information to investors and other users of financial statements. Currently, the accounting for a lease depends on its classification; an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRSs or U.S. GAAP, whereas a capital lease results in the lessee recognizing an asset and an obligation. Under the proposed guidance, lessees would only have one method of accounting for leases, which would produce more complete and comparable financial reporting in addition to reducing the opportunity to structure transactions to achieve a desired accounting outcome.

.262 The scope of the new lease guidance includes all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. Under this new guidance, all lessees would use a single method of accounting for all leases: an asset would be recognized representing the lessee's right to use the leased (underlying) asset for the lease term (the right-of-use asset), and a liability at the present value of the expected lease payments would also be recognized.

.263 A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either (*a*) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or (*b*) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach). The assets and liabilities recognized by both lessors and lessees would be measured on the basis that

- assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- a remeasurement is triggered when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

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.264 For leases of 12 months or less, lessors and lessees would be able to apply simplified requirements. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. New disclosures would also be required.

.265 In early 2009, the boards issued a discussion paper on leases; this exposure draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors, regulators, and other interested parties since that discussion paper. The comment period is open until December 15, 2010. During the comment period, the boards will undertake further outreach activities, including public round-table meetings to ensure that the views of all interested parties are taken into consideration before the new standard is completed. Also, the boards will share and jointly consider all comment letters received. A final standard is expected in the second quarter of 2011. The AICPA has developed questions and answers to highlight the important aspects of the proposals, which can be located at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/DownloadableDocuments/EDITED_LEASES_FAQ.pdf.

Auditing Considerations of Accounting Convergence

.266 Although the future of convergence between IASB and FASB accounting standards remains an unknown, discussions have already begun about the potential impact on auditors. Although auditors are accustomed to new standards, the nature and volume of these changes will likely pose new challenges. Among others, some of these potential challenges include the following:

- Training audit staff on a large amount of new accounting guidance that is based on an accounting approach (that is, principles based versus rules based)
- Developing, as necessary, any new internal audit guidance, such as firm methodology
- Implementing any new resulting auditing rules
- Creating a new framework for documenting audit conclusions on a principles-based accounting approach
- Audit committees learning new accounting guidance to effectively perform their function

.267 In addition to the challenges auditors will face, the effects on preparers will also be great. At the time of this writing, it appears that the transition timeline to convergence will be relatively short; this will divert resources during the preparation of financial statements as entities focus on implementing the new principles, which may result in increased audit risk. Auditors, in addition to preparers, are also encouraged to remain current on developments of international accounting convergence.

FASB Accounting Pipeline

Disclosure of Certain Loss Contingencies

.268 In July 2010, FASB issued an exposure draft on the disclosure of certain loss contingencies in response to concerns from investors and other financial statement users that the current disclosures do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. The objective of these disclosures would be for an entity to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following: the nature of the loss contingencies, their potential magnitude, and their potential timing (if known). Disclosure of certain remote loss contingencies would be required and, therefore, would expand the population of loss contingencies that are required to be disclosed. An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required. Further, current qualitative disclosures would be enhanced by requiring additional disclosures. These additional required qualitative and quantitative disclosures include the following:

- For litigation contingencies, the contentions of the parties and how users can obtain more information about the litigation
- Publicly available quantitative information, such as the claim amount for asserted litigation contingencies; other relevant nonprivileged information; and, in some cases, information about possible recoveries from insurance and other sources
- For public entities, tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the period

.269 The amendments in this proposal would affect all entities. The exposure draft noted that FASB will continue to work with the PCAOB, the AICPA, and the American Bar Association (ABA) to identify and address any potential implications of the proposed amendments for auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The proposed amendments would be effective for fiscal years ending after December 15, 2010, for public entities and in the first annual period beginning after December 15, 2010, for nonpublic entities. The comment period ended in September 2010.

Going Concern FASB Project

.270 Currently, the only guidance on going concern resides in the auditing literature, and this project's intention is to incorporate going concern guidance into U.S. GAAP. Specifically, this guidance would discuss the following:

- Preparation of financial statements as a going concern
- An entity's responsibility to evaluate its ability to continue as a going concern
- Disclosure requirements when financial statements are not prepared on a going concern basis
- Disclosure requirements when there is a substantial doubt about an entity's ability to continue as a going concern
- The adoption and application of the liquidation basis of accounting

.271 A revised exposure draft is expected to be issued in the fourth quarter of 2010, with a final ASU expected in the first quarter of 2011. FASB has decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Readers should be alert to developments on this topic.

Other Accounting Projects

.272 Additionally, FASB has the following projects underway:

- Troubled debt restructuring
- Disclosure framework
- Investment properties

Resource Central

.273 The following are various resources that practitioners engaged in the insurance industry may find beneficial.

Publications

.274 Practitioners may find the following publications useful. Choose the format best for you—online or print.

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- Audit and Accounting Guide *Life and Health Insurance Entities* (2010) (product no. 0126310 [paperback], WLH-XX [online], or DLH-XX [CD-ROM])
- Audit and Accounting Guide *Property and Liability Insurance Entities* (2010) (product no. 0126710 [paperback], WPL-XX [online], or DPL-XX [CD-ROM])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2010/11* (product no. 0223010 [paperback])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2009* (product no. 0223009 [paperback])
- Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709 [paperback] or WIA-XX [online])
- *Accounting Trends & Techniques, 63rd Edition* (product no. 0099009 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099109 [paperback] or WIF-XX [online])
- *Life and Health Insurance Entities*—Checklists and Illustrative Financial Statements (product no. 0089509 [paperback])
- *Property and Liability Insurance Entities*—Checklists and Illustrative Financial Statements (product no. 0089609 [paperback])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Financial Reporting Alert *Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

AICPA Online Professional Library: Accounting and Auditing Literature

.275 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification*™, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC on in the Online Professional Library (product no. WFA-XX [online]).To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.276 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop (2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.

- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Strong Foundation* (product no. 741602 [text], 181601 [DVD/Manual], or 351601 [Additional Manual for DVD]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

.277 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.278 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.279 To register or learn more, visit www.cpa2biz.com.

Webcasts

.280 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.281 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.282 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.283 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the

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application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

The Center for Audit Quality

.284 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.285 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit www.aicpa.org/InterestAreas/CenterForAuditQuality/Pages/CAQHome.aspx.

AICPA Industry Expert Panel—Insurance

.286 For information about the activities of the AICPA Insurance Industry Expert Panel, visit the panel's Web page at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/INSURANCE/Pages/Insurance.aspx.

Industry Websites

.287 The Internet covers a vast amount of information that may be valuable to auditors of insurance entities, including current industry trends and developments. Some of the more relevant sites for auditors with insurance clients include those shown in the following table:

Organization	*Website*
Alabama Insurance Underwriting Association (AIUA)	www.alabamabeachpool.org
Citizens Property Insurance Corporation of Florida (Florida Citizens)	www.citizensfla.com
Florida Hurricane Catastrophe Fund (FHCF)	www.sbafla.com/fhcf
Insurance Information Institute (III)	www.iii.org
Louisiana Citizens Property Insurance Corporation	www.lacitizens.com
Mississippi Residential Property Insurance Underwriting Association (MRPIUA)	www.msplans.com/MRPIUA
Mississippi Windstorm Underwriting Association (MWUA)	www.msplans.com/mwua
National Association of Insurance Commissioners (NAIC)	www.naic.org
Texas Windstorm Insurance Association (TWIA)	www.twia.org

.288 The insurance practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org

(continued)

Website Name	*Content*	*Website*
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov

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AAM Section 8050

Financial Institutions Industry Developments: Including Depository and Lending Institutions and Brokers and Dealers in Securities—2010/11

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Financial Institutions Industry Developments: Including Depository and Lending and Brokers and Dealers in Securities—2009*.

This Audit Risk Alert is intended to provide auditors of financial statements of financial institutions, including depository and lending institutions and brokers and dealers in securities, with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Feedback

The Audit Risk Alert *Financial Institutions Industry Developments: Including Depository and Lending and Brokers and Dealers in Securities* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform audits for your financial institutions, including depository and lending institutions and brokers and dealers (broker-dealers) in securities, and also can be used by an entity's internal management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/2011* (product no. 0223310) explains important issues that affect all entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic Developments

The Current Economy

.03 When planning and performing audit engagements, an auditor should understand both the general economic conditions and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, real estate values, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

.04 Although many key indicators, such as unemployment, are still high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. Further, after experiencing a considerable decline in the stock market through March 2009, the markets rebounded. In March 2009, the S&P 500 and the Dow Jones Industrial Average (DJIA) reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002. By March 2010, only 1 year later, all 3 had increased in value by at least 59 percent

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from the previous year's lows. However, all 3 remained relatively unmoved 5 months later, in late September 2010. This exhibits the continuing uncertainty in the markets due to the varying economic indicators, the financial reform regulatory changes, political uncertainty in the United States with midterm elections, and foreign economies, among other reasons. The fear of a double-dip recession (a recession followed by a short-lived recovery followed by another recession) continues to loom over the U.S. economy. The research firm StrategyOne reported in early September that 65 percent of Americans believe that a double-dip recession is likely to occur.

Key General Economic Indicators

.05 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.06 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.7 percent in the second quarter of 2010 (third estimate), 3.7 percent in the first quarter of 2010, and 5.6 percent in the fourth quarter of 2009. This data indicates a turnaround in the economy because in the fourth quarter of 2008 and the first quarter of 2009, real GDP decreased 6.3 percent and 5.5 percent, respectively. In early October 2010, when the Troubled Asset Relief Program (TARP) had expired, the Treasury reported that more than $200 billion in TARP funds had been recovered and that taxpayers made $28 billion in profit to date. Ninety percent of the total $700 billion TARP funds will not have been spent or will be returned to taxpayers. However, a portion of the TARP funds, including dividend repayments, and other federal assistance programs have not yet been repaid. The direct budget cost of the total program is estimated to cost well under $50 billion.

.07 From September 2009 to September 2010, the unemployment rate fluctuated between 9.5 percent and 10.1 percent. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. (An unemployment rate of 10.0 percent represents approximately 15.3 million people.) One reason for the continued high unemployment rate is that more Americans are resuming their search for work.

.08 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points, prior to the financial crisis, to less than 0.25 percent, where it remained through October 2010. The Federal Reserve described the current economic recovery in its September 21, 2010, press release as follows:

- Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software is rising, though less rapidly than earlier in the year, and investment in nonresidential structures continues to be weak.
- Employers remain reluctant to add to payrolls.
- Housing starts are at a depressed level.
- Bank lending has continued to contract but at a reduced rate in recent months.
- The pace of economic recovery is likely to be modest in the near term.

.09 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant its holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the beginning of the financial market turmoil in August 2007, the Federal Reserve's balance sheet has grown from $869 billion to $2.3 trillion.

.10 In addition, the Federal Reserve's *Summary of Commentary on Current Economic Conditions* (commonly known as the Beige Book), from September 2010, provides additional information on bank lending activity.

The Beige Book stated that lending activity was stable to down slightly from the previous month, with little or no change from existing low levels of commercial and industrial lending, as businesses remained cautious about expansion plans. Commercial real estate lending remained subdued, and loan standards were still tight.

.11 See the "Banks and Savings Institutions," "Credit Unions," "Broker-Dealers in Securities," and "Commodities" sections in this alert for additional industry-specific economic information.

Legislative Developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.12 On July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law in response to weaknesses in the financial services industry that were believed to have contributed to the recent economic recession. The Dodd-Frank Act was approved by the House of Representatives on June 30, before narrowly clearing the Senate on July 15. As the economy is slowly recovering from the worst economic downturn since the Great Depression, this reform represents the greatest change to financial regulation since that time. The two main goals of the reform are to lower the systemic risks of the financial system and enhance consumer protections.

.13 The Dodd-Frank Act, among many other changes, will create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisers. It mandates over 60 different studies and reports by various oversight agencies on a range of issues. Because these new regulations will most likely be produced over the next few years, the impact of these reforms will be staggered. This may provide opportunities for the financial institutions industry to respond to the proposed regulations and work with regulators in developing reporting requirements, formats, and timetables that are practical to implement. It will also enable both regulators and the industry to meet their individual goals, which is important to the efforts to avoid market disruptions and inadvertently increase systemic risk. Large, complex financial institutions, in particular, and newly regulated entities with new reporting requirements will be challenged to update their systems, policies, procedures, and data infrastructures. Although the Dodd-Frank Act contains many provisions, some highlights that may be of particular interest to auditors are summarized in the following sections.

Financial Stability Oversight Council

.14 The Dodd-Frank Act creates a new systemic risk regulator called the Financial Stability Oversight Council (FSOC) to be led by the Treasury secretary. The two main goals of the FSOC are to identify risks to the financial stability of the United States and to promote market discipline by eliminating the moral hazard of "too big to fail." To meet these goals, the FSOC has many powers and will identify any company, product, or activity that could threaten U.S. financial stability. The FSOC has the power to designate nonbank financial entities as systemically important and, through the Office of Financial Research, may collect reports from any bank holding entity or nonbank financial entity for the purpose of determining whether it poses a threat to U.S. financial stability. These entities will be under the supervision of the Federal Reserve. The FSOC will be chaired by the Treasury secretary, and members will be heads of banking regulatory agencies, including the chairmen of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Securities and Exchange Commission (SEC), among others. For those large entities deemed a threat to U.S. financial stability, the FSOC can, under the new orderly liquidation authority, authorize the FDIC to close such entities. The FSOC, through the Federal Reserve, will have the power to preemptively require a large, complex entity to divest some of its holdings if it poses a grave threat to the stability of the United States, although this is intended only as a last resort.

.15 The FSOC will make recommendations to the Federal Reserve with respect to capital adequacy, leverage, liquidity, risk management, and other requirements as entities grow in size and complexity, with significant requirements for entities that pose a risk to the financial system. Further, the FSOC is required to

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conduct a study on the feasibility, benefits, costs, and structure of a contingent capital requirement. Contingent capital would effectively be subordinated to other forms of debt and would convert to common equity in times of financial stress.

.16 The FSOC also has monitoring and reporting responsibilities. It will review and, as appropriate, submit comments to the SEC and any other standard-setting body (for example, the Financial Accounting Standards Board [FASB]) with respect to an existing or proposed accounting rule. Further, the FSOC must annually report to Congress significant financial market and regulatory developments, including accounting and insurance regulations, along with assessing their possible impact on the financial system's stability. The FSOC also has the ability to veto rules created by another new regulator, the Bureau of Consumer Financial Protection (BCFP), with a two-thirds vote. Lastly, it will make recommendations on implementation of the Volcker Rule (which is subsequently described in the "Derivatives Trading" section of this alert) to aid regulators. The first meeting of the FSOC was in October 2010.

Leverage and Risk-Based Capital Requirements

.17 Title I, "Financial Stability," of the Dodd-Frank Act requires the appropriate federal banking agencies to establish minimum leverage and risk-based capital requirements, on a consolidated basis, for insured depository institutions (IDIs), depository institution holding companies, and nonbank financial companies supervised by the Federal Reserve. The minimum leverage and risk-based capital requirements for IDIs established by the agencies under this section of the Dodd-Frank Act shall not be less than the generally applicable requirements, which shall serve as a floor for any capital requirements that the agencies may require, nor be quantitatively lower than the generally applicable requirements that were in effect for IDIs as of the date of enactment. Title 1 of the Dodd-Frank Act addresses deductions from regulatory capital and includes the following provisions:

- Trust-preferred securities issued by bank and thrift holding companies after May 19, 2010, will no longer count as tier 1 capital. Trust-preferred securities may otherwise qualify to be treated as tier 2 capital.
- Trust-preferred securities issued before May 19, 2010, by bank and thrift holding companies with $15 billion or more in assets will continue to be treated as tier 1 capital until January 2013. Then, the tier 1 capital treatment will be phased out over a 3-year period.
- Bank and thrift holding companies with assets of less than $15 billion as of December 31, 2009, will be permitted to include trust-preferred securities that were issued before May 19, 2010, as tier 1 capital.
- These provisions of the Dodd-Frank Act do not apply to small bank holding companies (holding companies with less than $500 million in assets).

.18 Title VI, "Improvements to Regulation," of the Dodd-Frank Act mandates stronger capital requirements for all IDIs, depository institution holding companies, and any company that controls an IDI and provides that any company in control be accountable for the financial strength of that entity. In establishing the capital requirements, the federal banking agencies seek to make the requirements countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction, consistent with safety and soundness.

Bureau of Consumer Financial Protection and Mortgage Reform

.19 The BCFP is the new independent agency (although it will be housed at the Federal Reserve) that consolidates most federal regulation of financial services offered to consumers. The BCFP is expected to ensure that consumers receive clear, accurate information to shop for mortgages, credit cards, and other financial products (but not products subject to securities or insurance regulations); to provide consumers with one dedicated advocate; and to protect them from hidden fees and deceptive practices. The BCFP will also oversee the enforcement of federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for individuals. The director of the BCFP replaces the director of the Office of Thrift Supervision (OTS) on the

FDIC board (the OTS was abolished by the Dodd-Frank Act). The BCFP will be led by an independent director appointed by the president and confirmed by the Senate, with a dedicated budget in the Federal Reserve. Certain functions currently handled by existing agencies are expected to be transferred to the BCFP, and the BCFP is expected to assume full authority for consumer financial protection no later than one year after enactment.

.20 The Dodd-Frank Act recognizes that CPAs providing customary and usual accounting activities (which include accounting, tax, advisory, or other services that are subject to the regulatory authority of a state board of accountancy) and other services incidental to such customary and usual accounting activities are already adequately regulated and, therefore, are not subject to the BCFP's authority. Activities that are outside the customary and usual activities may be subject to BCFP regulation; thus, CPAs may not have full exemption.

.21 The BCFP has the authority to examine and enforce regulations for banks and credit unions with assets of over $10 billion, as well as all mortgage-related businesses (nondepository institution lenders, servicers, mortgage brokers, and foreclosure operators); providers of payday loans; and student lenders, as well as other nonbank financial entities, such as debt collectors and consumer reporting agencies. Banks and credit unions with assets of $10 billion or less will be examined for consumer compliance by the appropriate regulator. The BCFP also is able to autonomously write rules for consumer protections governing all financial institutions (banks and nonbanks) offering consumer financial services or products.

.22 For mortgage reform, a simple federal standard is established for all home loans that requires a nondepository institution to have a reasonable basis to expect that borrowers can repay their loans. Lenders and mortgage brokers who do not comply with the new rules prohibiting unfair lending practices will be held accountable through imposed penalties. The Dodd-Frank Act does not address the government-sponsored entities Fannie Mae and Freddie Mac—they will be addressed separately through future legislation.

Sarbanes-Oxley Section 404(b) Exemption

.23 The Dodd-Frank Act amends SOX to make permanent the exemption from its Section 404(b) requirement for nonaccelerated filers (those with less than $75 million in market capitalization) that had temporarily been in effect by order of the SEC. Section 404(b) of SOX requires companies to obtain an auditor's report on management's assessment of the effectiveness of the company's internal control over financial reporting. It is important to note that Section 404(a) of SOX, which requires management's assertion (report) on internal control over financial reporting, is still required for nonaccelerated filers. The Dodd-Frank Act also requires the SEC to complete a study within 9 months of the act's enactment on how to reduce the burden of Section 404(b) SOX compliance for companies with market capitalizations between $75 million and $250 million. The study will consider whether any such methods of reducing the burden, or a complete exemption, would encourage companies to list on U.S. exchanges. The Government Accountability Office (GAO) is also required to conduct a study to evaluate whether issuers that are exempt from Section 404(b) requirements have fewer or more restatements than those that are required to comply, how the cost of capital compares for exempt issuers, whether any difference exists in investor confidence in the integrity of the financial statements of exempt versus complying issuers, and whether exempted entities should be required to disclose to investors the absence of Section 404(b) attestation and the costs and benefits of voluntary compliance. The report of findings from the second study is due to Congress within 3 years.

.24 In September 2010, the SEC issued Final Rule Release Nos. 33-9142; 34-62914, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, to conform its rules to this resulting change from the Dodd-Frank Act.

.25 Section 112 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) added Section 36, "Early Identification of Needed Improvements in Financial Management," to the Federal Deposit Insurance Act (FDI Act) (*Banks and Banking*, *U.S. Code* Title 12, Section 1831m). Part 363 of the FDIC's

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regulations (Title 12 U.S. *Code of Federal Regulations* [CFR] Part 363) implements Section 36 of the FDI Act.[1] Section 36 of the FDI Act and 12 CFR 363 require each IDI with $1 billion or more in total assets to file an annual report that includes, among other items, an assessment by management on the effectiveness of the IDI's internal control over financial reporting and an independent public accountant's attestation report concerning the effectiveness of the IDI's internal control structure over financial reporting. The permanent exemption from Section 404(b) of SOX does not affect the requirement for an IDI with $1 billion or more to include an independent public accountant's attestation report concerning the effectiveness of the IDI's internal control structure over financial reporting in its Part 363 Annual Report.

Auditors of Nonpublic Broker-Dealers

.26 Prior to the Dodd-Frank Act, in 2008, SEC Release No. 34-54920, *Extension of Order Regarding Broker-Dealer Financial Statement Requirements under Section 17 of the Exchange Act*, expired, and as a result, financial statements of nonpublic broker-dealers for fiscal years ending after December 31, 2008, must be audited by a PCAOB-registered public accounting firm. The expiration of the SEC's order resulted in over 500 accounting firms with broker-dealer audit clients registering with the PCAOB. Any balance sheet, income statement, or other financial statement required to be filed by a nonpublic broker-dealer must be audited by a public accounting firm registered with the PCAOB. Although auditors of nonpublic broker-dealers were required to register with the PCAOB, they were not subject to the PCAOB's standard-setting, inspections, investigatory, or disciplinary authority. The Dodd-Frank Act addresses this limitation.

.27 Section 982 of the Dodd-Frank Act provides for the PCAOB to create a program for inspecting the auditors of nonpublic broker-dealers, including standard setting and enforcement. Section 982 amends Section 102 of SOX to specifically mandate that auditors of nonpublic brokers-dealers follow the same standards and requirements as auditors of issuers. This section of the Dodd-Frank Act also permits the PCAOB to refer investigations, as well as release documents and information gathered in investigations, to a registered broker-dealer's self-regulating organizations.

.28 The Dodd-Frank Act allows the PCAOB, in its inspection rule, to potentially differentiate among auditors of nonpublic broker-dealer classes and to potentially exempt auditors of introducing brokers (IBs) (those who do not engage in clearing, carrying, or custody of client assets) from its inspection program.

.29 The PCAOB is also authorized to identify public accounting firms that lack expertise or fail to exercise care in audits of broker-dealers, identify and address audit deficiencies, and suspend or bar noncompliant registered public accounting firms from conducting broker-dealer audits. SOX, as amended, will also require broker-dealers to pay an annual accounting support fee to the PCAOB. The fee is intended to offset the cost of PCAOB oversight of auditors of broker-dealers and will be allocated among broker-dealers proportionately based on their net capital.

.30 Because of the time and steps involved in the promulgation of any new rules for nonissuers applicable to both nonisser broker-dealers and auditors of nonissuer broker-dealers, the PCAOB has indicated that it is unlikely that the new nonissuer broker-dealer auditing standards would be implemented by 2011. This implementation would likely occur in 2012. However, limited inspections of auditors of nonissuer broker-dealers may be performed in 2011.

.31 See the "SEC Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Broker-Dealers" section in this alert for additional information regarding an SEC interpretation related to this rule.

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[1] Section 36, "Early Identification of Needed Improvements in Financial Management," of the Federal Deposit Insurance Act (*Banks and Banking*, *U.S. Code* Title 12, Section 1831m) and its implementing regulation, Part 363 of the Federal Deposit Insurance Corporation's (FDIC's) regulations (Title 12 U.S. *Code of Federal Regulations* [CFR] Part 363) can be found at www.fdic.gov/regulations/laws/rules/1000-3800.html#fdic1000sec.36 and www.fdic.gov/regulations/laws/rules/2000-8500.html, respectively. Also, the FDIC's Financial Institution Letter 33-2009, which includes the final rule regarding the most recent amendments to 12 CFR 363, is located at www.fdic.gov/news/news/financial/2009/fil09033.html.

PCAOB and Foreign Auditor Oversight

.32 The PCAOB is now authorized, in certain circumstances, to share information with foreign audit oversight authorities. This will facilitate PCAOB cooperation with its foreign counterparts and PCAOB inspection of non-U.S. firms. When SOX was enacted, few other countries had similar audit oversight bodies; therefore, no provisions in SOX existed to authorize sharing information with foreign authorities. Since then, many countries have established, or are in the process of establishing, similar audit oversight bodies.

.33 Further, any registered public accounting firm (domestic or foreign) that relies, in whole or in part, on the work of a foreign public accounting firm in issuing an audit report, performing audit work, or conducting an interim review must (*a*) produce the foreign firm's audit working papers and all related documents if the SEC or PCAOB requests them and (*b*) secure the foreign firm's agreement to produce those documents as a condition of relying on the work of that firm. Any foreign firm that performs work for a domestic registered public accounting firm must provide the domestic firm with written consent and power of attorney designating the domestic firm as an agent on whom the SEC or PCAOB may serve a request for documents. Any foreign firm that performs material services on which a registered public accounting firm relies must designate to the SEC or PCAOB an agent in the United States on whom the SEC or PCAOB may serve a request for documents. The SEC or PCAOB may allow a foreign firm to meet document production obligations through alternate means, such as through the SEC's or PCAOB's foreign counterparts.

SEC Study Regarding Obligations of Broker-Dealers and Investment Advisers

.34 Under Section 913 of the Dodd-Frank Act, the SEC is required to conduct a study regarding the obligations of broker-dealers and investment advisers within six months of the date the Dodd-Frank Act was signed into law. The study will evaluate the effectiveness of existing legal or regulatory standards of care for broker-dealers (readers may refer to the discussion regarding obligations of broker-dealers to conduct reasonable investigations in Regulation D offerings in the subsequent "Broker-Dealers in Securities" section in this alert) and investment advisers; recommendations about securities to retail customers imposed by the SEC and a national securities association; and other federal and state legal or regulatory standards. In addition, the study will evaluate whether there are legal or regulatory gaps, shortcomings, or overlaps in legal or regulatory standards in the protection of retail customers relating to the standards of care for broker-dealers and investment advisers that should be addressed by rule or statute.

.35 In addition, following the study, the SEC is authorized to write rules addressing the legal and regulatory standards of care. Under the Dodd-Frank Act, the SEC is specifically given authority to establish a fiduciary duty for broker-dealers. The SEC may write rules to provide that the standard of conduct for a broker-dealer providing personalized investment advice about securities to a retail customer (and possibly other customers) should be the same as the standard of conduct applicable to an investment adviser under the Investment Advisers Act of 1940.

.36 As required by the Dodd-Frank Act, on July 27, 2010, the SEC published a request for public comment to solicit input regarding the obligations and standards of care of broker-dealers and investment advisers providing personalized investment advice about securities to retail investors.

.37 To facilitate public comment on these issues, as well as future requests for comment, the SEC is providing links on its website at www.sec.gov/spotlight/regreformcomments.shtml. The public can provide preliminary comments on topics, including over-the-counter (OTC) derivatives, hedge funds, corporate disclosure, and credit rating agencies, and other areas in which the SEC will be engaged in rulemaking and studies over the next 18 months.

Derivatives Trading

.38 The Dodd-Frank Act provides the SEC and the Commodity Futures Trading Commission (CFTC) with the authority to regulate OTC derivatives and requires central clearing and exchange trading for derivatives. The SEC will have authority over specific security-based swaps (including credit default swaps). The CFTC

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will have authority over all other swaps, including energy-rate swaps, interest-rate swaps, and broad-based security group or index swaps. Standardized swaps will be traded on an exchange or in other centralized trading facilities, which will promote transparency; standardized derivatives will also have to be handled by central clearinghouses. *Cleared* is defined as when trades are routed through a central clearinghouse that covers losses if a party to the trade is unable to complete the transaction. As a safeguard, many derivative traders will also be required to post margin to ensure all obligations can be paid and to offset the general risks that derivative trading poses to the financial system.

.39 The Dodd-Frank Act requires all cleared swaps to be traded on a registered exchange or board of trade. Many challenges surround this requirement, including that the standardization required of exchange-traded contracts could make it difficult for financial institutions to execute hedge strategies and achieve hedge effectiveness under hedge accounting rules. Clearing and exchange trading requirements are expected to become effective 360 days following enactment.

.40 The Dodd-Frank Act also provides regulators the authority to impose capital and margin requirements on swap dealers and major swap participants, not end users. By making the market more transparent, the pricing of common kinds of derivatives from the open marketplace may be reduced and would allow a wider range of entities to hedge their risks; customized derivatives could still have higher prices. The credit exposure from derivative transactions will be considered in banks' lending limits.

.41 Banks are allowed to continue engaging in principal transactions involving interest-rate, foreign-exchange, gold, silver, and investment-grade credit default swaps, subject to Volcker Rule limitations on proprietary trading. (Under the Volcker Rule of the Dodd-Frank Act, a banking entity will now be prohibited from proprietary trading; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or private equity fund. See the "Ending 'Too Big to Fail'" section of this alert for additional information.) For commodities, most other metals, energy, and equities, banks will have to shift their swap operations to a separately capitalized affiliate within the holding entity. Under an end-user exemption, nonfinancial firms can still use derivatives to hedge and manage the commercial risks associated with their business.

Securitization

.42 The Dodd-Frank Act also makes changes to securitization rules. Entities that sell products such as mortgage-backed securities will now be required to retain at least 5 percent of the credit risk, unless the underlying loans meet standards that reduce the risk. Issuers of these securities will also be required to disclose more information about the underlying assets, including analysis of the quality of the underlying assets. A study is mandated by the Dodd-Frank Act regarding the impacts of the new credit risk retention requirements and FASB Accounting Standards Update (ASU) No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, and No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*, on asset-backed securities (ABS). See the "Regulation AB" section in this alert regarding the SEC's proposed rules to address ABS and proposed risk retention requirements.

Registered Investment Advisers and Hedge Funds

.43 The Dodd-Frank Act will require advisers to hedge funds and private equity funds with over $150 million in assets to register with the SEC and be subject to its oversight. Advisers to venture capital funds remain exempt from registration, as well as advisers to private funds if such advisers act solely as advisers to private funds and have U.S. assets under management below $150 million. Currently, the Investment Advisers Act of 1940 requires investment advisers with over $30 million in assets under management to register with the SEC. Under the new reform, this threshold for federal regulation will be raised to $100 million, with certain exceptions. This change will increase the number of small advisers under state supervision and will allow the SEC to focus on newly registered hedge funds. Advisers will provide information about their trades and portfolios that is necessary to assess their systemic risk. The exemption in the Investment Advisers Act of 1940 for advisers with fewer than 15 clients has also been eliminated.

Investment advisers, now including hedge funds, must take steps to safeguard client assets over which such advisers have custody, including, without limitation, verification of such assets by an independent public accountant, as the SEC may, by rule, prescribe. The new registration requirements will become effective 1 year after enactment; however, any investment adviser may, at the discretion of the investment adviser, register with the SEC during that 1-year period. The Dodd-Frank Act also raises the standard for individuals to qualify as accredited investors, a basic threshold for purchasing private investments; these investors must now have $1 million in net assets, excluding the value of their primary residence. The prior standard was simply $1 million.

SEC and Investor Protections

.44 Because it lowers the legal standard from "knowing" to "knowing or reckless," the Dodd-Frank Act may make it easier for the SEC to prosecute aiders and abettors of those who commit securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934 (Exchange Act), the Investment Company Act of 1940, and the Investment Advisers Act of 1940. This change will increase the difficulty for a defendant to avoid a civil enforcement action because the SEC does not have to show the person intended to aid another person's violation but only that reckless conduct furthered the violation. The SEC and the Department of Justice will also now have the authority to bring civil and criminal law enforcement proceedings involving transnational securities frauds.

.45 Additionally, the Dodd-Frank Act authorizes 2 studies on these matters. One of the studies directs the GAO to investigate the impact of authorizing private rights of action for aiding and abetting claims and to release its findings within 1 year. The second study directs the SEC to examine whether private rights of action should be authorized for transnational or extraterritorial claims, and that study is to be completed within 18 months.

.46 The Office of the Investor Advocate will also be created within the SEC to identify areas in which investors have significant problems dealing with the SEC and to provide them with assistance. Another responsibility of this office will be to identify areas in which investors would benefit from changes in the regulations of the SEC.

.47 A whistle-blower program with rewards to encourage securities violations reports was created by the Dodd-Frank Act. An exception is provided for any whistle-blower who gains information through the performance of an audit of financial statements. Employers are prohibited from retaliating against whistle-blowers. Subsidiaries and affiliates that are consolidated with public companies for financial accounting purposes will become subject to the whistle-blower protections in SOX.

.48 The SEC is permitted to use fee collections to establish a reserve fund of up to $100 million, which can be used to fund special projects. The SEC may submit its annual budget directly to Congress without requiring the prior approval of the White House. The SEC has publicly stated that it will need to hire approximately 800 new employees to carry out the new reforms, given the new required enforcement, the 5 offices created within the SEC, the studies to be carried out, and the development of the specifics of new regulations.

Executive Compensation

.49 The Dodd-Frank Act requires a nonbinding shareholder vote on executive pay and golden parachutes for public companies. At a public company's first shareholder meeting following the end of the six-month period after enactment, management must give shareholders the opportunity to vote on how frequently shareholders will have a "say on pay" (that is, annually, every two years, or every three years). This is intended to give shareholders the power to hold executives accountable. Although the vote is nonbinding, a "No" vote by shareholders may force management to respond in some way. The SEC will have the authority to grant shareholders proxy access to nominate directors, which is intended to help shift management's focus from short-term profits to long-term growth and stability. The SEC is allowed to exempt small businesses from this requirement. The SEC issued a proposed proxy access rule last year but has been waiting for the clear legal authority that the Dodd-Frank Act provides prior to moving ahead with a final rule. The SEC is already in

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the process of drafting proxy access rules for public comment. The Dodd-Frank Act also requires entities to disclose in their annual proxy statement the median of annual total compensation to all employees other than their CEO, annual total compensation of the CEO, and the ratio of these two amounts. Disclosure is also required on why the chairman of the board and CEO positions are separate or combined.

.50 Incentive-based compensation that is based on financial statements that are restated to correct errors must be returned for the three years preceding the restatement in an amount equal to the excess of what would have been paid under the restated results. This is required regardless of whether the executive was involved in the noncompliance that led to the restatement. Listing exchanges will enforce the compensation policies. The Dodd-Frank Act also requires directors of compensation committees to be independent of the entity (*independent* as defined by its exchange) and its management. The members of that committee are required to select consultants, legal counsel, and other advisers only after taking into account independence factors established by the SEC. New disclosures regarding compensation will also be required, such as the incentive-based compensation policies. Further, the SEC is required to clarify disclosures on compensation, including requirements to provide information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.

.51 Overall, the level and complexity of the relationships that entities have with their regulators will increase from the passage of the Dodd-Frank Act. Already, many entities have chief risk officers who reside above any risk management structures inside business units and manage the firm's overall risk profile. This position creates a single senior point of contact for regulators seeking a high-level understanding of where a firm may have risk concentrations with possible systemic implications.

Ending "Too Big to Fail"

.52 The Dodd-Frank Act is intended to reduce the risk that large firms will take excessive risk because they believe they will, in effect, be rescued in the event of failure, as evidenced during the recent economic recession. Although that is an intent of the specific changes required by this reform, whether that goal will be achieved can only be determined over time. The goal is that taxpayers will not again be responsible to save a failing financial entity or cover the cost of its liquidation.

.53 The Volcker Rule, as previously stated, prohibits banking entities from proprietary trading; acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and sponsoring a hedge fund or private equity fund. *Proprietary trading* consists of transactions made by an entity that affect the entity's own account but not the accounts of its clients. Banks are allowed to make de minimis investments in hedge funds and private equity funds using no more than 3 percent of their tangible common equity in all such funds combined. Also, a bank's investment in a private fund may not exceed 3 percent of the fund's total ownership interest. Nonbank financial institutions supervised by the Federal Reserve will also have restrictions on proprietary trading, hedge fund investments, and private equity investments.

.54 The Dodd-Frank Act also requires certain financial entities to periodically submit plans for their rapid and orderly shutdown should the company go under (a "funeral plan" or "living will"). Each Federal Reserve-supervised nonbank financial company and bank holding company with at least $50 billion in total consolidated assets are required to report periodically to the Federal Reserve, the FSOC, and the FDIC regarding their plans. Entities that fail to submit acceptable plans will have higher capital requirements and restrictions on growth and activity, as well as divestment (in other words, sell or otherwise transfer assets or off-balance sheet items to unaffiliated entities).

.55 Additionally, an orderly liquidation mechanism for the FDIC to unwind failing systemically significant financial entities that pose a risk to the financial system has been created. Shareholders and unsecured creditors bear losses, and management and culpable directors will be removed. The FDIC will only be allowed to borrow funds to liquidate an entity when it expects to be repaid from the assets of the entity being liquidated, and the government will be first in line for repayment. Funds that are not repaid from the sales of the entity's assets will be repaid first through the clawback of any payments to creditors that exceeded liquidation value and then through assessments on large financial entities (with the riskiest ones paying

more). Taxpayers will bear no cost for liquidations. In addition, the Federal Reserve will be prohibited from rescuing an individual entity. To prevent "runs" on banks, the FDIC can guarantee the debt of solvent insured banks but only after meeting stringent requirements. The FDIC has prepared a summary of the Dodd-Frank Act that focuses on some particular areas related to the FDIC, such as those previously mentioned. This summary can be found on the FDIC's website at www.fdic.gov/regulations/reform/summary.pdf.

Thrift Regulations

.56 Title III, "Transfer of Powers to the Comptroller, the FDIC, and the FED," of the Dodd-Frank Act abolishes the OTS, the current federal supervisor for thrifts and thrift holding companies, and transfers authority mainly to the Office of the Comptroller of the Currency (OCC), which also regulates federally chartered national banks. However, the thrift charter has been preserved. The transfer of responsibilities is to take place one year after the promulgation of the Dodd-Frank Act, though provisions allow for extensions of that deadline if necessary.

.57 In addition, the Dodd-Frank Act provides that all orders; resolutions; determinations; agreements; and regulation interpretative rules, other interpretations, guidelines, procedures, and advisory material issued, made, or proscribed by the OTS remain in effect and shall remain enforceable by the OCC, the FDIC, or the Federal Reserve. See Section 316 of the Dodd-Frank Act for additional information.

Other Bank Regulations

.58 The Dodd-Frank Act permanently increases the maximum deposit insurance amount for banks, thrifts, and credit unions to $250,000 and retroactively applies the limit to January 1, 2008. The FDIC is directed to amend its regulations to define the assessment base as average total consolidated assets minus average tangible equity and to increase the minimum reserve ratio for the Deposit Insurance Fund (DIF) from 1.15 percent to 1.35 percent, exempting institutions with assets of less than $10 billion from the assessment.

.59 The prohibition of banks paying interest-on-demand deposits has been repealed. Additionally, the Dodd-Frank Act removes the ability for a bank to convert its charter (unless both the old and new regulator do not object) in order to avoid an enforcement action.

.60 Cash limits on Securities Investor Protection Corporation (SIPC) protection are also increased from $100,000 to $250,000, subject to periodic adjustments for inflation.

Rating Agencies

.61 Rating agencies became subject to increased scrutiny, given their role in the subprime mortgage crisis. The Dodd-Frank Act creates an Office of Credit Ratings at the SEC that must examine credit rating agencies at least once per year and make key findings public. These agencies will now be subject to expert liability with the nullification of Rule 436(g) of the Securities Act of 1933. This rule had provided an exemption for rating agencies from liability for statements about their ratings made in registration statements and prospectuses. Under the Dodd-Frank Act, in order to include a credit rating agency's rating in a registration statement, the registrant must file the credit rating agency's consent along with the registration statement. This will make credit rating agencies vulnerable to lawsuits when underwriters include their assessments in documents used to sell debt; they will now face the same legal risks as accountants and other parties who participate in bond sales. Investors can now bring private rights of action against rating agencies for a knowing or reckless failure to conduct a reasonable investigation of the facts or to obtain analysis from an independent source. The SEC also has the authority to deregister a credit rating agency for providing bad ratings over time. The SEC will be required to investigate any conflicts of interest involved in financial entities from picking the agency they believe will give them the highest ratings. Credit rating agencies will be required to disclose their methodology and track record. The SEC will conduct a study on the feasibility of a public or private entity that would be responsible for the assignment of a credit rating to the credit rating agencies.

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Conclusions

.62 The impact of these new reforms on the capital markets and credit availability is difficult to predict. The reforms have a widespread effect, and the full extent may take years to fully understand. Although strengthening transparency is an appropriate response to the recent economic recession, it has yet to be seen how the more stringent rules will affect the financial system and economic recovery.

.63 A copy of the full Dodd-Frank Act, as signed by the president, can be found at www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/BILLS-111hr4173ENR.pdf. The AICPA is also following any developments related to the Dodd-Frank Act on our website at www.aicpa.org under "Advocacy—Federal Issues."

Regulatory Developments

.64 The following provides general regulatory actions finalized or proposed by the Federal Reserve, the FDIC, the OCC, the OTS, and the National Credit Union Administration (NCUA) (collectively, the federal financial institution regulators); the CFTC; the SEC; and other regulatory agencies. See the "Regulatory Accounting Issues and Developments" section for regulatory actions that specifically affect certain accounting issues of financial institutions.

Federal Financial Institutions Regulators

Use of Credit Ratings

.65 In regard to the use of credit ratings, Section 939A of the Dodd-Frank Act requires the federal agencies to review regulations that (*a*) require an assessment of the creditworthiness of a security or money market instrument and (*b*) contain references to, or requirements regarding, credit ratings. In addition, the agencies are required to remove such references and substitute in their place uniform standards of creditworthiness, where feasible. The federal banking agencies, including the OCC, the Federal Reserve, the FDIC, and the OTS, issued an Advanced Notice of Proposed Rulemaking (ANPR), *Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies*, on August 16, 2010, in response to this requirement.

.66 This advance notice describes the areas in the capital rules where the agencies rely on credit ratings, as well as the Basel Committee on Banking Supervision's (Basel Committee's) amendments to Basel II. The advance notice solicits comment on alternative standards of creditworthiness that could be used in lieu of credit ratings; it also seeks comment on a range of potential approaches, including basing capital requirements on more granular supervisory risk weights or market-based metrics, as well as on how these approaches might apply to different exposure categories. It also requests comment on the feasibility of, and burden associated with, alternative methods of measuring creditworthiness for banking organizations of varying size and complexity. The ANPR and the request for comments can be found at www.gpo.gov/fdsys/pkg/FR-2010-08-25/pdf/2010-21051.pdf. A summary of the ANPR can be found on the FDIC's website at www.fdic.gov/news/news/financial/2010/fil10052.html.

Interagency Advisory on Interest Rate Risk Management

.67 On January 6, 2010, the banking regulatory agencies, including the Federal Financial Institutions Examination Council (FFIEC) and the State Liaison Committee, issued *Advisory on Interest Rate Risk Management* to remind institutions of supervisory expectations regarding sound practices for managing interest rate risk (IRR). In the current environment of historically low short-term interest rates, it is important for institutions to have robust processes for measuring and, when necessary, mitigating their exposure to potential increases in interest rates. Institutions are expected to have sound risk management practices in place to measure, monitor, and control IRR exposures. Accordingly, each of the financial regulators has established guidance on the topic of IRR management, which is included in the appendix of the interagency guidance. The entire text of this advisory can be found at www.fdic.gov/news/news/press/2010/pr1002.pdf.

Correspondent Concentration Risks

.68 On April 30, 2010, the federal banking regulatory agencies issued interagency guidance on correspondent concentration risks to outline the agencies' expectations for identifying, monitoring, and managing correspondent concentration risks between financial institutions. This guidance also addresses the agencies' expectations relative to performing appropriate due diligence on all credit exposures to, and funding transactions with, other financial institutions. Financial institutions that maintain credit exposures in, or provide funding to, other financial institutions should have effective risk management programs for these activities. Credit or funding exposures may include, but are not limited to, "due from" balances; federal funds sold as principal; direct or indirect loans (including participations and syndications); and trust preferred securities, subordinated debt, and stock purchases of the correspondent. The entire text of this guidance can be found at www.fdic.gov/news/news/financial/2010/fil10018a.pdf.

Banks and Savings Institutions

.69 According to industry trends, as reported by the FDIC, results from the beginning of 2010 from insured commercial banks and savings institutions have shown some positive signs for the industry. Lower provisions for loan losses and reduced expenses for goodwill impairment, in general, are helping to improve earnings of many banks and savings institutions. Although positive signs have emerged, many institutions continue to experience repercussions from the economic crisis. The FDIC reported that the number of institutions reporting quarterly financial results continues to decline as the number of failed FDIC-insured institutions and the number of institutions that have merged into other charters continue to increase. In addition, the number of insured commercial banks and savings institutions on the FDIC's "problem list" and the amount of "problem" assets continue to rise. The following table highlights these trends:

Historical Trends for FDIC-insured Institutions as of June 30, 2010[2]

	YTD 2010	*2009*	*2008*	*2007*
Commercial Banks	6,676	6,839	7,085	7,283
Savings Institutions[3]	1,154	1,173	1,219	1,251
Problem Institutions[4]	829	702	252	76
Failed Institutions	86	140	25	3

.70 Comptroller of the Currency John C. Dugan said in a speech in early 2010 that although the vast majority of community banks are sound, nearly 80 percent of community national banks have CAMELS ratings of 1 or 2; a growing minority have ratings that are lower.[5] Since the start of the crisis, most of the banks that have failed have been community banks.

.71 The interagency *Shared National Credits Program 2010 Review*[6] found that credit quality remained weak but improved with respect to large corporate loans and loan commitments held by U.S. bank organizations, foreign bank organizations, and nonbanks. Although the volume of criticized assets declined by more than

[2] Readers are encouraged to obtain the most recent *FDIC Quarterly* and other FDIC-insured institution statistics at www.fdic.gov/bank/statistical/stats/index.html.

[3] The number of savings institutions include both FDIC-supervised and Office of Thrift Supervision (OTS)-supervised institutions.

[4] Federal regulators assign a composite rating to each financial institution based on an evaluation of financial and operational criteria. The rating is based on a scale of one to five in ascending order of supervisory concern. *Problem institutions* are those institutions with financial, operational, or managerial weaknesses that threaten their continued financial viability. Depending upon the degree of risk and supervisory concern, they are rated either a four or five. The number and assets of problem institutions are based on FDIC composite ratings.

[5] See Office of the Comptroller of the Currency (OCC) Release 2010-32, *Comptroller Dugan Urges Action on Commercial Real Estate Concentrations*, dated March 19, 2010, at www.occ.treas.gov/ftp/release/2010-32.htm.

[6] The annual *Shared National Credits Program 2010 Review* results are prepared and released jointly by the Federal Reserve, the FDIC, the OCC, and the OTS. Results of the review are based on analyses prepared in the second quarter of 2010 using credit-related data provided by federally supervised institutions as of December 31, 2009, and March 31, 2010.

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30 percent from 2009's record level and the severity of classifications lessened, the volume and percentage of criticized and classified assets remained at historically high levels. Performance of the shared national credits portfolio remained heavily influenced by its significant exposure to 2006 and 2007 vintage credits with weak underwriting standards. Readers are encouraged to review the report in its entirety at www.federalreserve.gov/newsevents/press/bcreg/bcreg20100928a1.pdf.

.72 The following sections provide information about regulatory developments affecting banking and savings institutions.

FDIC Assessments

.73 On April 13, 2010, the FDIC board approved the Notice of Proposed Rulemaking *Assessments* that would (*a*) revise the risk-based assessment system for all large IDIs and (*b*) alter the initial and total base assessment rates for all IDIs. The proposed changes would be effective January 1, 2011.

Transaction Account Guarantee Extension

.74 On April 13, 2010, the FDIC adopted an interim final rule extending the Transaction Account Guarantee (TAG) Program component of the Temporary Liquidity Guarantee Program for 6 months, through December 31, 2010, with the possibility of extending the program an additional 12 months without further rulemaking. For institutions choosing to remain in the TAG Program, the basis for calculating the current assessments is modified to one that uses average daily balances in TAG-related accounts. Interest rates on negotiable order of withdrawal accounts guaranteed under the TAG Program are also lowered. See the FDIC's Financial Institution Letter (FIL)-15-2010, *Transaction Account Guarantee Extension*, on the FDIC website at www.fdic.gov/news/news/financial/2010/fil10015.html for additional information. The interim rule became effective on April 19, 2010.

.75 Section 343 of the Dodd-Frank Act amended the FDI Act to provide temporary unlimited insurance coverage to noninterest-bearing transaction accounts. This amendment will be in effect from December 31, 2010, to December 31, 2012, and it will replace the FDIC's TAG Program. The Dodd-Frank Act defines the noninterest-bearing transaction accounts eligible for this unlimited insurance protection more narrowly than the FDIC's TAG Program regulations. The Dodd-Frank Act also provides this unlimited insurance coverage to noninterest-bearing transaction accounts at all FDIC-insured institutions. To support the FDIC's administration of DIF in response to Section 343, all banks, including those that had not elected to participate in the FDIC's TAG Program, must begin to report the quarter-end dollar amount and number of noninterest-bearing transaction accounts (as defined in the Dodd-Frank Act) of more than $250,000, beginning December 31, 2010. The instructions for reporting estimated uninsured deposits will also be revised as of that date to reflect the temporary change in insurance coverage resulting from Section 343. Draft-revised instructions are available on the FFIEC's website at www.ffiec.gov/ffiec_report_forms.htm.

Regulation AB

.76 The SEC proposed significant revisions to Regulation AB and other rules regarding the offering process, disclosure, and reporting for ABS on April 7, 2010, which are broadly consistent with the Dodd-Frank Act's requirements for ABS. The proposals would revise filing deadlines for ABS offerings to provide investors with more time to consider transaction-specific information, including information about the pool assets.

.77 The proposals would repeal the current credit ratings references in shelf eligibility criteria for asset-backed issuers and establish new shelf eligibility criteria that would include, among other things, a requirement that the sponsor retain a portion of each tranche of the securities that are sold and a requirement that the issuer undertake to file Exchange Act reports on an ongoing basis, so long as its public securities are outstanding. The proposal would require the sponsor or an affiliate of the sponsor to generally retain a net economic interest in each securitization of 5 percent of the nominal amount.

.78 The SEC also proposed to require that with some exceptions, prospectuses for public offerings of ABS and ongoing Exchange Act reports contain specified asset-level information about each of the assets in the pool. The asset-level information would be provided according to proposed standards and in a tagged data format using Extensible Markup Language.

.79 Along with the provisions previously addressed, the Dodd-Frank Act mandates a number of significant changes to the regulation of ABS offerings. In response, the SEC issued a proposed rule, *Extension of Filing Accommodation for Static Pool Information in Filings With Respect to Asset-Backed Securities*. The proposed rule would extend by 18 months the temporary filing accommodation in Rule 312 of Regulation S-T that allows static pool information required to be disclosed in a prospectus of an asset-backed issuer to be provided on an Internet website under certain conditions. This accommodation was included in the SEC's final rule, *Extension of Filing Accommodation for Static Pool Information in Filings With Respect to Asset-Backed Securities*, issued in December 2009. The proposal would apply to filings with respect to ABS filed on or before June 30, 2012. The proposal was issued on August 30, 2010. See the proposed rule at www.sec.gov/rules/proposed/2010/33-9137.pdf for more information.

Certain Large IDIs

.80 On May 12, 2010, the FDIC issued FDIC FIL-26-2010, *Special Reporting, Analysis and Contingent Resolution Plans at Certain Large Insured Depository Institutions*, a proposed rule that would require certain IDIs that are affiliates of large and complex financial companies to submit to the FDIC analysis, information, and plans that address and demonstrate the insured institution's ability to be separated from its parent structure and to be wound down or resolved in an orderly fashion. Following standards set forth in the proposed rule, and subject to the FDIC's review and validation, covered IDIs would submit information and contingent resolution plans that would allow the FDIC to assess the risks posed to the deposit insurance fund and to develop effective resolution strategies and conduct contingency planning for a period of severe financial distress. The proposal would apply only to IDIs with greater than $10 billion in total assets that are owned or controlled by parent companies with more than $100 billion in total assets.

Basel Committee

.81 The Basel Committee approved for consultation a package of proposed measures to strengthen global capital and liquidity regulations and to strengthen the Basel II Framework. These proposed measures, commonly referred to as Basel III, aim to (*a*) improve the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source; (*b*) improve risk management and governance; and (*c*) strengthen banks' transparency and disclosures. The reforms target (*a*) bank-level, or microprudential, regulation, which will help raise the resilience of individual banking institutions to periods of stress; (*b*) macroprudential, systemwide risks that can build up across the banking sector; as well as (*c*) the procyclical amplification of these risks over time. The Basel Committee's oversight body—the Group of Central Bank Governors and Heads of Supervision (GHOS)—agreed on the broad framework of Basel III in September 2009, and the Basel Committee set out concrete proposals in December 2009. These consultative documents formed the basis of the Basel Committee's response to the financial crisis and are part of the global initiatives to strengthen the financial regulatory system that have been endorsed by the G-20 leaders. The GHOS subsequently agreed on key design elements of the reform package at its July 2010 meeting and on the calibration and transition to implement the measures at its September 2010 meeting, including the definition of *capital*, the treatment of counterparty credit risk, the leverage ratio, and the global liquidity standard. The draft Basel III regulations include (*a*) a tighter definition of *tier 1 capital*—banks must hold 4.5 percent by January 2015, then a further 2.5 percent capital conservation buffer, totaling 7 percent; (*b*) the introduction of a leverage ratio; (*c*) a framework for counter-cyclical capital buffers; (*d*) measures to limit counterparty credit risk; and (*e*) short- and medium-term quantitative liquidity ratios. Press releases describing the most recent decisions made by the committee can be found at www.bis.org/list/press_releases/said_7/index.htm.

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Credit Unions

.82 Credit unions continue to be affected by the economic issues. Although federally insured credit unions reported improved earnings performance and overall slight decline in loan delinquencies through the second quarter of 2010, the industry, in many areas of the country, continues to experience negative trends, including a rising number of costly credit union failures. Credit unions in these areas continue to experience a higher level of loan losses and loan modifications. The NCUA anticipates sizeable losses by credit unions during the remainder of 2010. Readers may find the most recent financial trends in federally insured credit unions, which are issued quarterly results though the *NCUA Letter to Credit Unions*, on the NCUA website at www.ncua.gov.

.83 One of the most significant financial and structural challenges to the credit union industry is related to the corporate credit union crisis. In 2009, the NCUA placed U.S. Central Federal Credit Union and Western Bridge Corporate Federal Credit Union into conservatorship, and on September 24, 2010, the NCUA board placed 3 additional corporate credit unions into conservatorship. These 5 corporate credit unions held more than 90 percent of the total impaired securities (legacy assets)—predominately private-label mortgage-backed securities—in the corporate credit union system.

.84 The following provides information regarding the NCUA's actions to address this crisis and reform the corporate credit union regulatory framework.

NCUA's 2010 Corporate Credit Union Rule

.85 On September 24, 2010, the NCUA finalized major revisions to 12 CFR 704 of the NCUA Rules and Regulations. The revisions

- establish a new capital structure, including risk-based capital requirements, to provide corporate credit unions with a stronger capital base.
- establish prompt corrective action requirements for corporate credit unions that allow the NCUA to take action with regard to undercapitalized corporate credit unions.
- include new limitations on corporate investments and credit risks, as well as asset-liability management controls, so that high concentrations of certain types of investments are not permitted.
- provide for greater NCUA oversight and control of corporate credit union service organization (CUSO) activities to protect against the possibility that systemic risk might migrate from corporate credit unions to their CUSOs.

.86 The new rule will be effective for 90 days after it is published in the *Federal Register*, and none of the new capital requirements will go into effective until October 2011. It is expected that many corporate credit unions will have to solicit and obtain capital from their members prior to October 2011 to meet the new regulatory standard.

.87 The NCUA has posted detailed information on the corporate credit union system resolution in a new "toolbox" on the NCUA website. The website provides historical and updated information on the stabilization actions taken by the NCUA, which include establishing the Temporary Corporate Credit Union Share Guarantee Program, the Temporary Corporate Credit Union Liquidity Guarantee Program, and the Temporary Corporate Credit Union Stabilization Fund. The website includes the NCUA's strategies regarding conservatorship of the five corporate credit unions and the corporate credit unions' legacy assets. It also provides additional background, history, and frequently asked questions (FAQs) related to the revised corporate credit union rule 12 CFR 704. This website may be accessed at www.ncua.gov/Resources/CorporateCU/CSRMain.aspx. The NCUA Letter to Credit Unions 10-CU-20, *NCUA's 2010 Corporate Credit Union Rule*, which announced the revisions to 12 CFR 704 may be found at www.ncua.gov/letters/2010/CU/10-CU-20.pdf. An attachment to this letter includes a matrix that summarizes the provisions of the NCUA's rules affected by this rulemaking, along with the effective dates for each provision.

Broker-Dealers in Securities

.88 Broker-dealers in securities continue to experience repercussions from the economic crisis and will continue to experience unprecedented changes within the industry as a result of the regulatory reform measures discussed throughout this alert.

SEC Circuit Breaker Rules

.89 On May 6, 2010, a market disruption occurred whereby the DJIA rapidly fell almost 1,000 points. Approximately 1 month later, the SEC approved rules that will require the exchanges and the Financial Industry Regulatory Authority (FINRA) to pause trading for 5 minutes in certain individual stocks if the price moves 10 percent or more in either direction in a 5-minute period. The pause would only apply to stocks in the S&P 500 and would give the markets the opportunity to attract new trading interest in an affected stock, establish a reasonable market price, and resume trading in a fair and orderly fashion. These rules are in effect on a pilot basis through December 10, 2010. The pilot period will be used to make appropriate adjustments to the parameters or operations of the circuit breakers based on experience, and the scope of the rules will be expanded to securities beyond the S&P 500 as soon as practicable. Additionally, the SEC is considering recalibrating marketwide circuit breaker rules that were already in effect in May 2010 but were not triggered during the May 6 minicrash. By the end of June, these circuit breakers had been set off twice—both times for erroneous trades. The SEC press release regarding these rules can be found at www.sec.gov/news/press/2010/2010-98.htm.

.90 At the end of June 2010, the SEC published for public comment proposals by the national securities exchanges and FINRA to expand the program to include all stocks in the Russell 1000 Index and certain exchange-traded fundss. The markets will continue to use the pilot period to make appropriate adjustments to the parameters or operations of the circuit breakers as warranted, based on their experience.

SEC Guidance on Liquidity and Capital Resources Disclosure

.91 On September 17, 2010, the SEC published interpretive guidance intended to improve the liquidity and capital resource disclosures in the "Management's Discussion and Analysis" (MD&A) section of SEC filings. The guidance provides insight into the SEC's preexisting disclosure rules and was not intended to create new disclosure requirements. This guidance can be reviewed at www.sec.gov/rules/interp/2010/33-9144.pdf.

New SEC Disclosures Impacting Quarter-End "Window Dressing"

.92 Currently, SEC rules require companies to disclose short-term borrowings at the end of a period. No requirement exists to disclose information about the specific amount of short-term borrowings outstanding throughout the reporting period. Investors have expressed concerns that certain public companies mask their liquidity positions by reducing short-term borrowings shortly before reporting dates. To address this concern, on September 17, 2010, the SEC proposed amendments to its requirements for disclosure relating to short-term borrowings. These proposed rules will require a registrant to provide enhanced disclosure regarding the use and impact of short-term borrowing arrangements throughout the relevant reporting period for the following categories of short-term borrowings: federal funds purchased and securities sold under agreements to repurchase, commercial paper, borrowings from banks, borrowings from factors or other financial institutions, and other short-term borrowings reflected on the registrant's balance sheet. In particular, registrants would be required under an amended Item 303 of Regulation S-K to provide disclosure of the following information for each of these categories of short-term borrowings:

- The amount of short-term borrowings outstanding at the end of the period and the weighted average interest rate on those borrowings
- The average amount outstanding during the period and the weighted average interest rate on those borrowings
- The maximum amount outstanding during the period

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.93 All registrants would be required to present information for each category of short-term borrowings, even when the relevant category represents only a small portion of the company's stockholders' equity at the end of the period. Registrants would be required to disaggregate the amounts shown for each category by currency, interest rate, or other meaningful criteria to the extent that presentation of separate amounts is necessary to promote understanding or prevent aggregate amounts from being misleading.

.94 Registrants would also be required to include a narrative discussion and analysis in the "MD&A" section to provide context for the tabular data. The new MD&A disclosure requirement is intended to provide investors with a discussion of the drivers of variations in the level of short-term borrowings outstanding during the period and at period-end.

.95 For purposes of calculating and reporting maximum and average amounts of short-term borrowings outstanding during the reporting period, financial companies would be required to provide averages calculated on a daily average basis, comparable with the calculations currently required for bank holding companies under Securities Act Industry Guide 3, "Statistical Disclosure by Bank Holding Companies," and to disclose the maximum amount outstanding on any day in the period. Nonfinancial companies would be required to calculate averages using an average period not to exceed one month and to disclose the maximum month-end amount during the period.

.96 The SEC has also proposed that substantially similar requirements be applicable to foreign private issuers in Item 5, "Operating and Financial Review and Prospects," of Form 20-F and that smaller reporting companies be granted certain exclusions from the most rigorous and costly features of the new requirements. Finally, the SEC has proposed conforming amendments to Items 2.03 and 2.04 of Form 8-K relating to short-term debt obligations. These proposed disclosures can be viewed at www.sec.gov/rules/proposed/2010/33-9143.pdf.

Custody Rule

.97 In December 2009, the SEC adopted rules designed to substantially increase the protections for investor funds and securities in the custody of an investment adviser registered with the SEC. Depending on the investment adviser's custody arrangement, the rules would require the adviser to be subject to surprise exams and custody control reviews that were generally not required under the previous rules. As amended, paragraph (a)(4) of Rule 206(4)-2 under the Investment Advisers Act of 1940 requires that all registered investment advisers (or investment advisers required to register) who have custody of client funds or securities, as defined, have an independent public accountant conduct an examination on a surprise basis once every calendar year. The independent public accountant must also file a certificate on Form ADV-E with the SEC within 120 days of the time chosen for the surprise examination by the independent public accountant stating that he or she has examined the funds and securities and describing the nature and extent of the examination. This surprise examination report follows the provisions of AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1).

.98 The rule defines *custody* to mean an investment adviser, or its related person, holding, directly or indirectly, client funds or securities or having any authority to obtain possession of them. Custody includes the following:

- Possession of client funds or securities (but not of checks drawn by clients and made payable to third parties)
- Any arrangement (including a general power of attorney) under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian
- Any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the investment adviser or his or her supervised person legal ownership of, or access to, client funds or securities

.99 A *qualified custodian* is defined by the rule as (*a*) a *bank*, as defined in Section 202(a)(2) of the Investment Advisers Act of 1940, or a *savings association*, as defined in Section 3(b)(1) of the FDI Act, that has deposits insured by the FDIC under the FDI Act; (*b*) a broker-dealer registered under Section 15(b)(1) of the Exchange Act that holds the client assets in customer accounts; (*c*) a futures commission merchant (FCM) registered under Section 4f(a) of the Commodity Exchange Act that holds the client assets in customer accounts, but only with respect to clients' funds and security futures, or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (*d*) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. Additionally, a *related person* is defined in the rule as any person, directly or indirectly, controlling or controlled by the investment adviser and any person that is under common control with the investment adviser.

.100 If the broker-dealer who is a registered investment adviser, or its related person, maintains client funds or securities as a qualified custodian in connection with advisory services provided to clients, Rule 206(4)-2(a)(6) under the Investment Advisers Act of 1940 requires that such investment adviser must at least once each calendar year obtain, or receive from its related person, a written internal control report related to its, or its affiliates', custodial services, including the safeguarding of funds and securities, which includes an opinion from an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB.

.101 This requirement could be satisfied with a type 2 service auditor's report under a Statement on Auditing Standards (SAS) 70 report or an examination report on internal control over compliance conducted in accordance with AT section 601. As explained in question XIII.3 of the SEC's *Staff Responses to Questions About the Custody Rule*, in addition to the two types of reports previously mentioned (and Release IA-2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*) that satisfy the requirements for an internal control report, a report under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1), would also be acceptable. As discussed in the "Service Organizations" section of this alert, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801), will replace the guidance previously found in SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324). Therefore, this type of report would also satisfy the internal control requirement. This internal control report must include an opinion about whether controls have been placed in operation as of a specific date and are suitably designed and are operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the investment adviser or its related person on behalf of the advisory clients during the year. The accountant must also verify that the funds and securities are reconciled to the records of a custodian other than the investment adviser or its related person (for example, the Depository Trust & Clearing Corporation). The accountant's tests of the custodian's reconciliation should include either direct confirmation, on a test basis, with unaffiliated custodians or other procedures designed to verify that the data used in the reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered.

.102 The AICPA Investment Companies Expert Panel developed an illustrative report of an independent registered public accounting firm on management's assertion regarding controls at a custodian pursuant to Rule 206(4)-2 under the Investment Advisers Act of 1940 and Release No. IA-2969, which can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/DownloadableDocuments/Custody_report_September_1final.pdf.

.103 Readers are encouraged to review the full text of Release No. IA-2968, *Custody of Funds or Securities of Clients by Investment Advisers*. The SEC released FAQs about the custody rule, which addresses investment advisers who may also act as an IB, among other topics, and that document is located at www.sec.gov/divisions/investment/custody_faq_030510.htm.

.104 Additionally, the AICPA Investment Companies Expert Panel also issued FAQs regarding the SEC's revised custody rule and guidance for accountants. The summary and FAQs were developed based on a review of the custody rule, the SEC's adopting release, the SEC staff's FAQs, and discussions with the SEC

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staff. The AICPA's FAQs can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/DownloadableDocuments/AICPA_IC_EP_FAQ_custody_rule_August_17.pdf.

.105 For additional information, see chapter 11, "Independent Auditor's Reports and Client Representations," of the AICPA Audit and Accounting Guide *Investment Companies* and the Audit Risk Alert *Investment Companies Industry Developments—2010/11*.

Exclusion From SIPC Membership

.106 Broker-dealers registered with the SEC, with some limited exceptions, are required to be members of the SIPC. The SIPC imposes an assessment upon members to maintain its fund and to repay any borrowings by the SIPC. Beginning April 1, 2009, the SIPC reinstituted an assessment rate of 1 quarter of 1 percent of each member's SIPC net operating revenues.

.107 The AICPA Stockbrokerage and Investment Banking Expert Panel developed an example of an illustrative independent accountants' report on applying agreed-upon procedures related to the entity's claim for exclusion from membership in the SIPC (Form SIPC-3), which is currently being reviewed by the specified parties. Once all parties have agreed, an illustrative example of such report will be posted on the AICPA website at www.aicpa.org/interestareas/accountingandauditing/community/investmentbanking/Pages/StockbrokerageInvestmentBanking.aspx.

Cost-Basis Reporting

.108 Beginning in 2011, broker-dealers and other financial institutions will be required to record and report to the IRS not only cost basis information of the institution's customers' securities but also the adjusted cost basis of any security that is sold. On February 1, 2010, the IRS released *Notice of Proposed Rulemaking and Notice of Public Hearing Basis Reporting by Securities Brokers and Basis Determination for Stock*. The proposed changes to the law, among others

- require brokers, when reporting the sale of securities to the IRS, to include the customer's adjusted basis in the sold securities and to classify any gain or loss as long term or short term.
- alter how taxpayers compute basis when averaging the basis of shares acquired at different prices and expand the ability of taxpayers to compute basis by averaging.
- alter how brokers report short sales of securities.

.109 To prepare for the new rules and reporting requirements, broker-dealers, banks, mutual funds, and other financial entities may be required to make substantial changes to internal operations, such as updating front- and back-office client interfaces, securities files, accounting systems, and reporting platforms. Other potential challenging issues may include the treatment of short sales, wash sales when the taxpayer has multiple brokerage accounts, dividend reinvestment plans, and securities purchased in foreign currencies. Comments on this proposal were due on February 8, 2010. Readers are encouraged to monitor the IRS for additional details regarding this proposal, which can be found in its entirety at www.irs.gov/irb/2010-05_IRB/ar09.html.

SEC Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Broker-Dealers

.110 On October 1, 2010, the SEC published Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, to clarify the application of certain SEC rules, regulations, releases, and staff bulletins, in light of the authority granted to the PCAOB in the Dodd-Frank Act. The SEC is considering a rulemaking project to update the audit and related attestation requirements under the federal securities laws for broker-dealers, in light of the Dodd-Frank Act. In addition, the PCAOB has not yet revised its rules, which currently refer only to issuers, to require registered public

accounting firms to comply with PCAOB standards for audits of nonissuer broker-dealers. The SEC release can be found at http://sec.gov/rules/interp/2010/34-62991.pdf.

Flash Orders

.111 The SEC reopened the period for public comment on a proposal to eliminate the flash order exception with respect to listed options under the Exchange Act. In September 2009, the SEC originally proposed to amend the rule to eliminate an exception for flash orders from quoting requirements under the Exchange Act. The exception applies to quotations that are executed immediately after communication or cancelled or withdrawn if not executed immediately after communication. The SEC is reopening the comment period to invite additional comment on the issues specifically related to listed options. The reopened proposal can be found on the SEC website at www.sec.gov/rules/proposed/2010/34-62445fr.pdf.

Risk Management Controls for Brokers-Dealers With Market Access

.112 In January 2009, the SEC proposed for comment new rules under the Exchange Act that would require broker-dealers with access to trading directly on an exchange or alternative trading system (ATS), including those providing sponsored or direct market access to customers or other persons, to implement risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of this business activity. Given the increased speed and automation of trading on securities exchanges and ATSs today and the growing popularity of sponsored or direct market access arrangements in which broker-dealers allow customers to trade in those markets electronically using the broker-dealers' market participant identifiers, the SEC is concerned that the various financial and regulatory risks that arise in connection with such access may not be appropriately and effectively controlled by all broker-dealers. Comments on the proposal, which were due on March 29, 2010, can be found on the SEC website at www.sec.gov/rules/proposed/2010/34-61379.pdf.

Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings

.113 In Regulatory Notice 10-22, *Obligation of Broker-Dealers to Conduct Reasonable Investigations in Regulation D Offerings*, issued in April 2010, FINRA reminds broker-dealers of their obligation to conduct a reasonable investigation of the issuer and the securities they recommend in offerings made under SEC Regulation D under the Securities Act of 1933—also known as private placements.

.114 This notice describes Regulation D and broker-dealers' regulatory responsibilities to engage in a reasonable investigation of a Regulation D offering, enforceable under the antifraud provisions of the federal securities laws and FINRA rules. It also describes specific issues that pertain to a broker-dealer's responsibilities and how the scope of a broker-dealer's responsibility to conduct a reasonable investigation will necessarily depend upon its affiliation with the issuer, its role in the transaction, and other facts and circumstances of the offering. This notice includes practices that some broker-dealers have adopted to help them perform their reasonable investigation obligations. The notice in its entirety can be found at www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p121304.pdf.

PCAOB Broker-Dealer Audit Considerations

.115 On July 15, 2010, prior to the finalization of the Dodd-Frank Act, the PCAOB held a meeting with its Standing Advisory Group to discuss broker-dealer audit considerations. Given the PCAOB's new oversight authority over broker-dealer audits, as noted in the "Auditors of Nonpublic Broker-Dealers" section of this alert, they expect to increase, among other things, their headcount, provide specialized training to their staff, and develop a system of accounting support fees. Unlike conventional audits, the SEC requires the audits of broker-dealers to include a review of the accounting system; the internal accounting controls and procedures for safeguarding securities; and the auditor to express an opinion on the computation of net capital, computation for determination of reserve requirements, and compliance with possession and control of customer securities requirements, in addition to the audit of the financial statements. However, the current SEC guidance states that the extent and timing of audit procedures are matters for the independent public

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accountant to determine on the basis of his or her review and the evaluation of existing internal controls. As such, the SEC's initial observation is that the PCAOB will need to issue or amend standards to provide specific procedures regarding the regulatory reports required by the SEC.

Mortgage Banking

New Department of Housing and Urban Development Requirements for Supervised Mortgagees,[7] Including Financial Institutions, for Financial Statement Audits in Accordance With Government Auditing Standards and Audits of Compliance With Requirements for Department of Housing and Urban Development-Assisted Programs

.116 The U.S. Department of Housing and Urban Development (HUD) issued notice of a Federal Housing Administration (FHA) program change as a result of Mortgagee Letter 2009-31, *Strengthening Counterparty Risk Management*, issued September 18, 2009 (and available at www.hud.gov/offices/adm/hudclips/letters/mortgagee/files/09-31ml.doc). This policy change affects all supervised mortgagees. Effective for fiscal years ending on or after January 1, 2010, all supervised mortgagees, including financial institutions, must submit annual audited financial statements to HUD within 90 days of their fiscal year-end. Additionally, a new requirement exists for a separate compliance audit. Previously, these requirements only applied to nonsupervised mortgagees (for example, a separate mortgage company).

.117 Certain questions have arisen regarding the application of existing HUD guidance to supervised mortgagees, an issue the AICPA is still pursuing with HUD. Upon gaining clarification from HUD, the AICPA will provide additional guidance to auditors in this area. In the meantime, some of what is included subsequently is based on assumptions and could change with clarification from HUD.

HUD Audit Requirements

.118 The mortgagee letter states that audited financial statements must be submitted in accordance with the HUD *Mortgagee Approval Handbook* and prepared and audited in accordance with HUD's Office of the Inspector General's most recent *Consolidated Audit Guide for Audits of HUD Programs* (audit guide). The HUD audit guide is available at www.hud.gov/offices/oig/reports/auditguide. At this time, HUD has not formally amended the HUD audit guide to refer to supervised mortgagees. Until HUD issues guidance clarifying this point or modifies the HUD audit guide to directly address supervised mortgagees, some auditors are assuming that chapter 7, "HUD-Approved Title II Nonsupervised Mortgagees and Loan Correspondents Audit Guidance," of the HUD audit guide is the relevant guidance that would apply to supervised mortgagees. HUD has informally confirmed to the AICPA that this is an appropriate course of action. The AICPA has asked HUD to formalize its position in this area through the issuance of clarifying implementation guidance or an update to the HUD audit guide. Additionally, both chapter 1, "General Audit Guidance," and chapter 2, "Reporting Requirements and Sample Reports," of the HUD audit guide apply to these audits.

.119 The HUD audit guide requires the auditor to issue the following reports:

- A report on the financial statements, with the auditor's report on accompanying supplemental information required by HUD
- A combined report on internal control over financial reporting and internal control over compliance for HUD-assisted programs, which is required to identify any significant deficiencies and material weaknesses noted
- A report on compliance with applicable laws and regulations that may have a direct and material effect on each HUD-assisted program, which includes an opinion on compliance

[7] This designation of a supervised mortgagee is limited to financial institutions that are members of the Federal Reserve System and financial institutions whose accounts are insured by the FDIC or the National Credit Union Administration. Examples of supervised mortgagees are banks, savings associations, and credit unions. For additional information, see the *Mortgagee Approval Handbook* on the U.S. Department of Housing and Urban Development website at www.hud.gov/offices/adm/hudclips/handbooks/hsgh/4060.1/index.cfm.

.120 Chapter 2 of the HUD audit guide provides illustrations of the previously described reports and describes additional reports that may be required to be issued in an audit, depending on the facts and circumstances.

.121 The previously described audits must be performed in accordance with generally accepted auditing standards (GAAS) (or PCAOB standards if the entity is an issuer) and the standards for financial audits of the U.S. GAO's *Government Auditing Standards* (GAS) issued by the comptroller general of the United States (and available at www.gao.gov/govaud/ybk01.htm). For financial audits, GAS incorporates the fieldwork and reporting standards of GAAS and the related SASs issued by the AICPA, unless specifically excluded or modified by GAS. Additionally, in conducting audits in accordance with GAS, auditors assume certain responsibilities beyond those of audits performed in accordance with GAAS.

.122 GAS describes ethical principles, establishes general standards, and establishes additional fieldwork and reporting standards beyond those required by GAAS. For example, an auditor must meet the GAS auditor qualifications, including the qualifications relating to independence and continuing professional education (CPE), which in some cases are more restrictive than GAAS. Additionally, the audit organization must meet the quality-control standards of GAS. A number of additional requirements exist. Chapters 1–4 of the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits* provide additional information on the GAS requirements that might be useful to auditors who are new to this area.

.123 As noted earlier, with regard to the compliance audit component of the new HUD requirements, chapter 7 of the HUD audit guide is the "assumed" primary source of audit guidance until HUD issues clarifying guidance or updates the HUD audit guide to specifically address supervised mortgagees. Auditors are also reminded that the recently issued SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801) (effective for fiscal periods ending on or after June 15, 2010), is applicable to the compliance audit component of these engagements.

New Electronic Submission Requirements and Related Agreed-Upon Procedures Engagement

.124 Financial statements and other financial and compliance data must be submitted electronically through the FHA's Lender Assessment Subsystem (LASS) for FHA review. The responsibility for this electronic submission rests with supervised mortgagees. Auditors are then required to perform a separate agreed-upon procedures engagement related to the electronic filing, which should be performed under AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*, vol. 1). The LASS User Manual (available at http://hud.gov/offices/hsg/sfh/lass/lass_usermanual.cfm) contains information that auditors will need to navigate the process. Of particular interest are the sections that provide instructions for auditors to obtain their user ID or registration information and the auditor's procedures.

.125 Section 7-4(B) of the HUD audit guide notes the following:

> The LASS templates only require the financial information of the approved mortgagee and not the consolidated entity. However, HUD will accept the audits of the consolidated financial statements of the parent if it includes consolidating schedules, audited by the auditor, which distinguish the balance sheet, operating statement and computation of adjusted net worth of the mortgagee/loan correspondent subject to the HUD audit requirement. These amounts are the amounts entered into LASS. The consolidating schedules must be subjected to the auditing procedures applied to the consolidated statement of the parent, and the auditor's opinion must cover the financial statement accounts of the subsidiary.

.126 It is unclear from this guidance whether the consolidating schedules are subject to audit at the entity level or subject only to AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1) (see the "Supplementary and Other Information Related to Financial Statements" section in this alert). Additionally, the LASS templates used to make the electronic submissions have not been formatted to reflect the typical financial statement presentation of supervised mortgagees, including an unclassified balance sheet. Again, the AICPA is working with HUD to gain clarity on both of these issues.

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.127 IDIs with $500 million or more in total assets that are subject to Section 36 of the FDI Act and its implementing regulation, 12 CFR 363, are required to file a Part 363 Annual Report that includes audited comparative annual financial statements; the independent public accountant's report thereon; a management report; and, if applicable, an independent public accountant's attestation report on management's assessment concerning the institution's internal control structure and procedures for financial reporting. These institutions are also required to file a copy of any management letter or other report issued by their independent public accountant with respect to the institution and the services provided by the independent public accountant. Institution management should review the filing requirements of 12 CFR 363 to determine whether the aforementioned reports filed with HUD should be filed as part of the institution's Part 363 Annual Report or other report in accordance with 12 CFR 363. Additionally, IDIs with less than $500 million in total assets should also consider the need to file the HUD reports with the FDIC; their primary federal regulator if it is not the FDIC; and any state authority, as required by FDIC FIL-96-99, *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations*, which can be found at www.fdic.gov/news/news/financial/1999/fil9996.html.

Commodities

.128 Global futures and options contract trading volume increased when comparing the first 6 months of 2010 with the same period in 2009. In the first 6 months of 2010, volume traded on U.S. futures exchanges amounted to 3.6 billion contracts, a 16 percent increase from the same period in 2009. Volume traded on foreign exchanges amounted to 7.6 billion contracts in the first six months of 2010. Trading volume in interest rate and equity products continued to account for more than half of worldwide trading volume.

.129 The total amounts required under CFTC regulations to be held in segregated or secured accounts on behalf of FCM customers decreased by $8 billion, from approximately $175 billion as of June 30, 2009, to approximately $167 billion as of June 30, 2010.

Off-Exchange Retail Foreign Currency Transactions

.130 The CFTC issued final regulations concerning off-exchange retail foreign currency transactions, effective October 18, 2010. The rules implement provisions of the Dodd-Frank Act and the Food, Conservation, and Energy Act of 2008, which, together, provide the CFTC with broad authority to register and regulate entities wishing to serve as counterparties to, or to intermediate, retail foreign exchange (forex) transactions.

.131 The final forex rules put in place requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital, and other business conduct and operational standards. Specifically, the regulations require

- counterparties offering retail foreign currency contracts as either FCMs or retail foreign exchange dealers (RFEDs), a new category of registrant, to be registered.
- persons who solicit orders, exercise discretionary trading authority, or operate pools with respect to retail forex to register as IBs, commodity trading advisers, commodity pool operators (CPOs) (as appropriate), or associated persons of such entities.
- otherwise regulated entities, such as U.S. financial institutions and SEC-registered broker-dealers, to serve as counterparties in such transactions under the oversight of their primary regulators.
- FCMs and RFEDs to maintain net capital of $20 million plus 5 percent of the amount, if any, by which liabilities to retail forex customers exceed $10 million.
- leverage in retail forex customer accounts to be subject to a security deposit requirement to be set by the National Futures Association (NFA), within limits provided by the CFTC.
- all retail forex counterparties and intermediaries to distribute forex-specific risk disclosure statements to customers and to comply with comprehensive recordkeeping and reporting requirements.

.132 The final rule can be found in the *Federal Register* at www.federalregister.gov/articles/2010/09/10/2010-21729/regulation-of-offexchange-retail-foreign-exchange-transactions-and-intermediaries#p-3.

Minimum Adjusted Net Capital Requirements of FCMs and IBs

.133 Effective as of March 31, 2010, the CFTC revised financial requirements for FCMs and IBs. The revised requirements affect FCM financial requirements as follows:

- Increase the minimum dollar capital requirement to $1 million
- Increase the risk-based capital requirement for noncustomer accounts from 4 percent to 8 percent of the total risk margin requirement for positions carried in noncustomer accounts
- Include cleared OTC derivative positions in an FCM's risk-based capital calculation for customer and noncustomer accounts

.134 The CFTC also revised the financial requirements for IBs by increasing the net capital requirement from $30,000 to $45,000. The CFTC's increase to the IB minimum capital requirement brings it to the same level currently required under section 5, "Introducing Broker Financial Requirements," of the *NFA Manual*. The final rule can be found at www.cftc.gov/LawRegulation/FederalRegister/FinalRules/e9-31058.html.

Exemption From Certain CFTC Regulations

.135 In May 2010, the CFTC published an informational and guidance document regarding the application procedure pursuant to CFTC Regulation 30.10, which generally provides that persons located and doing business outside the United States, and who are subject to a comparable regulatory framework in the country in which they are located, may qualify for an exemption from the application of certain CFTC regulations, including relief from registration as an FCM. For more information, please refer to www.cftc.gov/International/ForeignMarketsandProducts/index.htm. Appendix A, "Interpretive Statement With Respect to the Commission's Exemptive Authority Under 30.10 of Its Rules," of Part 30 of the CFTC's regulations generally outlines the procedure for a foreign regulator or self-regulatory organization seeking to obtain relief on behalf of a foreign broker subject to its oversight. As the operating division responsible for evaluating applications pursuant to Regulation 30.10, the Division of Clearing and Intermediary Oversight (DCIO) prepared and published a more detailed description of the information set forth in appendix A. In particular, the guidance is intended to streamline the application process by informing prospective Regulation 30.10 applicants of the information generally requested by the DCIO when evaluating applications for Regulation 30.10 relief.

CPO Reporting

.136 The CFTC amended its regulations governing the periodic account statements that CPOs are required to provide to commodity pool participants and, effective for 2009, the annual financial reports that CPOs are required to provide to commodity pool participants and file with the NFA. The amendments became effective December 9, 2009, and changes that affect annual reporting requirements were applicable to commodity pool annual reports for fiscal years ending December 31, 2009, and later. The amendments

- specify detailed information that must be included in the periodic account statements and annual reports for certain commodity pools with more than one series or class of ownership interest.
- clarify that the periodic account statements must disclose either the net asset value (NAV) per outstanding participation unit in the pool or the total value of a participant's interest or share in the pool.
- extend the time period for filing and distributing annual reports of commodity pools that invest in other funds.
- codify existing CFTC staff interpretations regarding the proper accounting treatment and financial statement presentation of certain income and expense items in the periodic account statements and annual reports.

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- streamline the final reporting requirements for pools ceasing operation.
- establish conditions for the use of International Financial Reporting Standards (IFRSs) in lieu of U.S. generally accepted accounting principles (GAAP) and a notice procedure for CPOs to claim such relief.
- clarify and update several other requirements for periodic and annual reports prepared and distributed by CPOs.

The CFTC Annual "Dear CPO" Letter

.137 On January 21, 2010, the CFTC staff issued its annual letter to CPOs outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The CFTC anticipates issuing a similar letter in January 2011. The letter emphasizes the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. The CFTC staff also suggests that CPOs share the letter with their independent auditors. Major concerns addressed in the letter include the following:

- Filing procedures and due dates of commodity pool financial filings
- Master-feeder and fund of funds
- Requests for limited relief from U.S. GAAP compliance for certain offshore commodity pools
- CPOs claiming exemption under CFTC Regulation 4.13
- Reports of liquidating pools
- Reports of series funds structured with a limitation on liability among the different series
- Accounting developments, including the following:
    - — FASB *Accounting Standards Codification*™ (ASC)
    - — Disclosures about derivative instruments
    - — AICPA Practice Aid *Audits of Futures Commissions Merchants, Introducing Brokers, and Commodity Pools*
    - — AICPA audit risk alerts
    - — FASB ASC 820, *Fair Value Measurements and Disclosures*
    - — Alternative investments audit and accounting considerations
    - — AICPA Technical Questions and Answers (TIS) section 6910.23, "Accounting Treatment of Offering Costs Incurred by Investment Partnerships" (AICPA, *Technical Practice Aids*)

.138 The CFTC has issued similar letters in prior years, which are available at the CFTC's website. Those letters should be consulted with respect to commodity pool annual financial statements and reporting. Readers are encouraged to view the full text of this letter at www.cftc.gov/ucm/groups/public/@iointermediaries/documents/file/cpoannualguidanceletter2009.pdf and monitor the CFTC website for the most recent guidance.

.139 Auditors may also consider additional CFTC guidance related to auditing regulatory supplementary schedules, maintaining minimum financial requirements and notification requirements, segregation of customer funds in multiple currencies, and foreign exchange transactions. Readers may refer to the Audit Risk Alert *Financial Institutions Industry Developments: Including Depository and Lending Institutions and Brokers and Dealers in Securities—2009* or the CFTC website at www.cftc.gov for additional details.

Depository Acknowledgement Letters

.140 In August 2010, the CFTC proposed amending Regulations 1.20, 1.26, and 30.7 concerning the acknowledgment letters that an FCM or derivatives clearing organization must obtain from any depository holding its segregated customer funds or funds of foreign futures or foreign options customers. The proposal sets out standard template acknowledgment letters that reaffirm and clarify the obligations that depositories incur when accepting segregated customer funds. For additional information, readers can find the press release at www.cftc.gov/PressRoom/PressReleases/pr5869-10.html.

Investment of Funds Deposited With Clearing Organizations and FCMs

.141 In 2009, the CFTC issued an advance notice of proposed rulemaking seeking public comment on possible changes to its regulations regarding the investment of customer funds segregated pursuant to Section 4d of the Commodity Exchange Act and funds held in an account subject to CFTC Regulation 30.7. Comment letters received have been analyzed, and a formal proposal is being circulated for CFTC approval.

The Dodd-Frank Act

.142 On July 21, 2010, the CFTC released the list of 30 areas of rulemaking to implement the Dodd-Frank Act. Some of these areas will require only 1 rule, but others may require more. The CFTC is required to complete these rules generally in 360 days, though some are required to be completed within 90, 180, or 270 days.

.143 The rule-writing areas have been divided into eight groups: Comprehensive Regulation of Swap Dealers & Major Swap Participants, Clearing, Trading, Data, Particular Products, Enforcement, Position Limits, and Other Titles.

.144 The CFTC is requesting input from the public on each of the rule-writing areas. Instructions for submitting views can be accessed on the individual rule-writing pages on the CFTC's website at www.cftc.gov/LawRegulation/OTCDerivatives/.

Agreed-Upon Procedures Report

.145 The CFTC staff is developing, in conjunction with industry and independent auditors, an agreed-upon procedures report for the segregation and secured amount schedules included in an FCM's annual audited financial report. The report is designed to provide greater assurance that FCMs are complying with the regulatory requirements surrounding the segregation and secured computations that are included in the annual report.

Commodity Pools

.146 The NFA adopted compliance rules applicable to CPOs as follows:

- Rule 2-45, "Prohibition of Loans by Commodity Pools to CPOs and Related Entities," prohibits a CPO from permitting a commodity pool to use any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity.
- Rule 2-46, "CPO Quarterly Reporting Requirements," effective for the quarter ended March 31, 2010, requires each CPO member to file certain information on a quarterly basis to the NFA, using the NFA's EasyFile System, for each pool it operates that has a reporting requirement under CFTC Regulation 4.22 (which includes exempt pools under CFTC Regulation 4.7). Within 45 days after the end of each quarterly reporting period CPOs must report the following:
    - — The identity of the pool's administrator, carry broker(s), trading manager(s), and custodian(s)
    - — A statement of changes in NAV for the quarterly reporting period

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— Monthly performance for the three months comprising the quarterly reporting period

— A schedule of investments identifying any investment that exceeds 10 percent of the pool's NAV at the end of the quarterly reporting period

Foreign Currency Exchange Transactions

.147 Effective October 1, 2010, the NFA amended Section 11(b)–(c) of the "Financial Requirements" section of the *NFA Manual* and its related Interpretive Notice 9053, *Forex Transaction* (www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9053&Section=9), to remove regulated foreign equivalents from the kinds of entities considered suitable locations for assets to be considered current for purposes of determining a Forex Dealer Member's (FDM's) adjusted net capital or to cover its currency positions. Therefore, FDMs will no longer be able to treat assets held at regulated foreign equivalents of such exempt entities as current.

.148 Notwithstanding this, the amendments will continue to permit the NFA to approve the use of certain foreign equivalent entities that are appropriately regulated and capitalized. Section (C)(3) of the related Interpretive Notice 9053 lists the factors that the NFA considers when determining whether to approve an otherwise unregulated entity for the purposes of Section 11(b)–(c).

Other Legislative and Regulatory Developments

The Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act

.149 In March 2010, the president signed into law a sweeping overhaul of the health care system. Almost everyone in the United States will be affected by these changes—individuals, insurance companies, health care providers, and employers. The three primary goals of the reform are to expand coverage to those without health insurance, reform the delivery system of benefits to improve quality, and decrease the costs of providing health care. The various provisions of the reform will become effective over time, through 2020. The new laws contain many changes for employers to consider for financial reporting purposes, in addition to many new tax rules to help offset the overall cost of the reform.

.150 The complete changes are contained in two acts. The Health Care and Education Reconciliation Act of 2010 was signed on March 30 and is a reconciliation bill that amends the Patient Protection and Affordable Care Act signed into law by the president one week earlier. In April, the SEC issued a staff announcement, *Accounting for the Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act*, to address questions that have arisen about the effect, if any, that the different signing dates might have on accounting for the two acts. This timing difference, related solely to the signing dates, should not have an impact on a majority of registrants because the acts were both signed within a relatively short time period, which for the vast majority of entities, falls into the same reporting period. However, there may be a limited number of registrants with a period-end that falls between the signing dates for which the timing difference could raise questions about whether the different signing dates have an accounting impact.

.151 After consultation with the FASB staff, the SEC's Office of the Chief Accountant would not object to a view that the two acts should be considered together for accounting purposes. That is, in this specific fact pattern, the SEC staff would not object to a registrant incorporating the effects of the Health Care and Education Reconciliation Act of 2010 when accounting for the Patient Protection and Affordable Care Act. This view is based in part on the SEC staff's understanding that the two acts, when taken together, represent the current health care reform as passed by Congress and signed by the president. The SEC staff does not believe that it would be appropriate to analogize to this view in any other fact patterns.

Significant Accounting and Tax Considerations of the Health Care and Education Reconciliation Act of 2010

.152 FASB ASC 740-10-30-2 states that the following basic requirements are applied to the measurement of current and deferred income taxes at the date of the financial statements:

- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

.153 FASB ASC 715-60-35-102 further explains that benefit coverage for medical claims by governmental programs or other providers of health care benefits should be assumed to continue as provided by the present law and other providers, pursuant to their present plans. Consistent with FASB ASC guidance, presently enacted changes in the law or amendments of the plans of other health care providers that take effect in future periods and that will affect the future level of their benefit coverage should be considered in current period measurements for benefits expected to be provided in those future periods. Future changes in laws concerning medical costs covered by governmental programs and future changes in the plans of other providers should not be anticipated.

.154 Accounting considerations resulting from this reform include the effects of the tax law changes on deferred income tax balances and other postretirement health benefits. One of the most significant changes relates to the government subsidy for providing qualifying prescription drug coverage to Medicare-eligible individuals that will no longer be deductible. The subsidy that certain employers are entitled to receive was created by the Medicare Prescription Drug, Improvement, and Modernization Act (MMA) of 2003. Under the MMA, employers that sponsor retiree health benefit plans and provide a benefit at least actuarially equivalent to Medicare Part D were eligible to receive a subsidy known as the retirement drug subsidy. These subsidy payments were not subject to income taxes. Under the new law, an entity's tax deduction is reduced by the subsidy for years beginning after December 31, 2012. Under income tax accounting rules, the impact on deferred tax assets is required to be adjusted in the period the MMA was signed into law, which, in this case, is the period ended March 31, 2010. Specifically, entities will need to reduce their income tax deduction for providing prescription drug coverage by the subsidy received from the government. In turn, they will record a charge to earnings to write off a portion of their deferred tax assets related to postretirement health care obligations. Such deferred tax assets were based on the gross liability amount. Because the tax deductible prescription drug costs liability will be reduced by the subsidy, the deferred tax asset will be computed net of the subsidy, resulting in a lower deferred tax asset. The federal subsidy will not reduce the tax deductions until 2013. Even though the changes may not be effective until future periods, the effects are accounted for in the period that includes the enactment date. FASB ASC 715-60 discusses accounting and reporting guidance for other postretirement plans, including the Medicare prescription drug plan. Many public entities have already posted large noncash charges in early 2010 related to the nondeductibility of the subsidy.

.155 Some of the other provisions of the reform that may affect an entity's tax position include the nondeductible pharmaceuticals fee, the medical device excise tax, and the therapeutic discovery project tax credit, which will have an effect on the pharmaceutical and medical device industries. Additionally, employer group health plans may not impose lifetime limits and can only impose "restricted" annual limits beginning with the 2011 plan year (for calendar year plans); no annual limits would be permitted beginning in 2014. Because these health benefits can no longer be limited, entities may need to increase accruals for future medical obligations. Many small businesses and tax-exempt organizations that provide health insurance coverage to their employees will now qualify for a special tax credit that is designed to encourage small employers to offer health care coverage for the first time or maintain the coverage they have.

.156 Lastly, under the new reform, a 40 percent penalty will apply to tax understatements attributable to transactions lacking economic substance (20 percent with adequate disclosure) or failing to meet the requirements of any similar rule of law. A transaction is treated as having economic substance only if the transaction

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changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

.157 The full text of these acts can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ152.111.pdf and http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ148.111.pdf. Readers are also encouraged to refer to the Audit Risk Alerts *Health Care Entities—2010/11* (product no. 0223410) and *Not-for-Profit Entities—2010* (product no. 0224210).

PCAOB Constitutionality

.158 On June 28, 2010, the Supreme Court ruled in a lawsuit challenging the constitutionality of the PCAOB. When the PCAOB was set up under SOX, its board members were appointed by the SEC and could be removed only for cause. The Supreme Court ruled, in a 5-4 vote, that although the manner in which the PCAOB was constituted was constitutionally invalid, SOX itself was not invalidated. Rather, the Supreme Court severed from the rest of SOX the provisions relating to the removal of PCAOB board members. The consequence of the Supreme Court's decision is that PCAOB board members will now be removable by the SEC at will, instead of only for good cause. Essentially, this decision has no material impact on the workings of the PCAOB, and all PCAOB programs will continue to operate as usual, including registration, enforcement, and standard-setting activities.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.159 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients. Some risks that may affect an entity in the current economic environment are as follows:

- Marginally achieving explicitly stated strategic objectives
- Weak real estate and business markets that may result in significant loan losses
- Continued measurement uncertainty, including accounting estimates and fair value measurements
- Potentially erroneous or fraudulent activity due to decreased staffing and resurgence of business activity
- Potentially fraudulent financial reporting due to low capital levels and the threat that the institution may fail
- The continuing evolution of the postrecessionary marketplace
- Violation of debt covenants, including accounting for modifications as well as appropriate disclosures
- Tight interest spreads
- Continued elevated levels of mortgage modifications and loan restructurings
- Substantial doubt about an entity's ability to continue as a going concern

.160 Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks that might give rise to material misstatements. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constantly changing status of economic conditions that could affect your client, auditors may consider changes in the environment throughout the audit and potentially modify audit procedures to ensure that risks are adequately addressed.

.161 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

PCAOB Observations Related to Audit Risk Areas Affected by the Economic Crisis

.162 In September 2010, the PCAOB released *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*. This report was issued to discuss the audit risks and challenges that resulted from the economic crisis that the PCAOB identified through its inspection program. This report covers inspections from the 2007–09 inspection cycles, which generally involved reviews of audits of issuers' fiscal years ending in 2006–08. The PCAOB's inspections covered by this report focused on audits of issuers in industries affected by the economic crisis. Thus, the PCAOB paid particular attention to audits of financial institutions industry issuers, including the larger financial institution audit clients.

.163 Heightened risk factors identified by the PCAOB that are of importance to financial institutions include fair value measurements, asset impairments, allowance for loan losses (ALL), and the consideration of an issuer's ability to continue as a going concern.

Fair Value Measurements

.164 The economic crisis increased uncertainty around fair value measurements, which significantly increased audit risk. Failing to properly test issuers' fair value measurements and disclosures may lead to the auditor not detecting a material misstatement in issuers' financial statements, which may cause investors to be misled.

.165 Firms inspected by the PCAOB tested issuers' estimates of fair value of financial instruments by performing procedures that included evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data. Deficiencies observed in audits of these tests included firms' failures to

- evaluate, or evaluate sufficiently, whether fair value measurements were determined using appropriate valuation methods.
- test, or adequately test, controls over issuers' valuation processes.
- evaluate, or evaluate sufficiently, the reasonableness of management's significant assumptions. Examples of this include not performing tests beyond inquiries of management; not appropriately evaluating the reasonableness of assumptions such as discount rates, credit loss expectations, and prepayment assumptions; and not involving a valuation specialist, when appropriate.
- evaluate available evidence that was inconsistent with issuers' fair value estimates.

.166 Alternatively, some firms evaluated issuers' estimates of fair value of financial instruments by developing an independent expectation of fair value. Firms often used external pricing services or external valuation specialists to make this evaluation. Deficiencies of the firms observed in this situation included failing to understand the methods or assumptions used by these external parties and failing to evaluate significant differences between the independent estimates used or developed by firms and the fair values recorded by issuers.

.167 Further, firms sometimes failed to test, or test sufficiently, significant, difficult-to-value securities (for example, limiting their testing to inquiries of issuer personnel). Firms also failed to perform sufficient procedures in light of the volatile market conditions to provide a reasonable basis for extending to year-end the conclusions regarding the valuation of investment securities that were reached at an interim date. There were also instances in which firms failed to perform sufficient tests to determine whether issuers' fair value disclosures were in conformity with the requirements of FASB ASC 820.

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Impairment of Goodwill, Indefinite-Lived Intangible Assets, and Other Long-Lived Assets

.168 Inspectors observed instances in which firms failed to challenge issuers' conclusions that goodwill did not need to be tested for impairment more frequently than annually despite the existence of impairment indicators, such as recent declines in issuers' stock prices or reduced estimates of future income in situations when such declines or reductions appeared to be potentially significant to issuers' most recent impairment analyses. In addition, inspectors observed that firms sometimes failed to test, or test appropriately, issuers' assessments that other indefinite-lived intangible assets or other long-lived assets were not impaired. In some cases, firms failed to evaluate the reasonableness of certain significant assumptions used by issuers in their impairment assessments.

Allowance for Loan Losses

.169 To audit an estimate, auditors should first gain an understanding of how management developed the accounting estimate and then perform one or a combination of the following: (*a*) review and test the process management used to develop the estimate, (*b*) develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate, or (*c*) review subsequent events or transactions occurring prior to the date of the auditor's report.

.170 PCAOB inspectors identified deficiencies related to procedures performed to evaluate the reasonableness of the ALL. These deficiencies included firms' failures to

- sufficiently test issuers' specific reserves on impaired loans. For example, firms sometimes failed to (*a*) sufficiently test issuers' conclusions regarding the identification and measurement of impaired loans, (*b*) perform procedures to establish a basis for relying on the work of certain issuer personnel, and (*c*) understand the methods and assumptions used by external parties engaged by issuers to perform appraisals of collateral underlying impaired loans.
- evaluate, or evaluate sufficiently, the effect on ALL of deficiencies identified in management's process and failure to alter the nature, timing, and extent of the testing of ALL in light of the identified deficiencies.
- evaluate, or evaluate sufficiently, the reasonableness of management's significant assumptions used to develop ALL, including assumptions about the nature or size of qualitative adjustments. For example, firms failed to evaluate the reasonableness of loss factors or other assumptions used to estimate ALL that were not directionally consistent with negative credit quality trends in loan portfolio performance or significant adverse conditions in the economic environment.
- test, or test sufficiently, the data underlying management's calculation of ALL. Specifically, firms sometimes failed to test, or test sufficiently, the completeness and accuracy of the data in system-generated or manually prepared reports used to develop ALL. These reports often formed the basis for significant inputs for the calculation of ALL, such as loan delinquency data, credit score information, value of loan collateral, and internally developed loan ratings.

.171 In other cases, firms evaluated the reasonableness of issuers' ALL by developing an independent expectation of ALL. When this approach was used, inspectors noted instances in which firms failed to obtain evidence to support the assumptions they used or failed to test the completeness and accuracy of the issuer's data used by the firm in developing the independent expectation.

Off-Balance Sheet Structures

.172 Inspectors observed deficiencies in firms' audit procedures related to off-balance sheet structures. Specifically, inspectors noted instances in which firms failed to (*a*) sufficiently test issuers' transactions with external parties or special purpose entities to determine whether such transactions were appropriately accounted for as off-balance sheet arrangements and (*b*) test the ongoing compliance with accounting requirements for certain off-balance sheet arrangements, including performing tests for the occurrence of events that would affect the accounting for these arrangements.

Other-Than-Temporary Impairment of Certain Investments

.173 Inspectors observed instances in which firms failed to adequately evaluate issuers' conclusions that a decline in the fair value of securities was not other than temporary. In these instances, inspection teams observed deficiencies that included firms' failures to

- evaluate, beyond inquiries of management, certain significant assumptions underlying issuers' assessments that investments in debt and equity securities were not other-than-temporarily impaired for significant classes of securities, including securities for which fair value had been below cost for a period greater than 12 months.
- evaluate issuers' assertions regarding their intent and ability to hold securities for a period of time sufficient to allow for any anticipated recovery in fair value.
- consider contradictory evidence, such as sales of securities or contractual agreements, that would call into question whether issuers had the intent and ability to hold the investment until recovery.

Conclusions

.174 The observations from this report will serve to inform future PCAOB actions in connection with certain inspection, enforcement, and standard-setting activities, and consideration will be given to whether additional guidance is needed relating to existing standards. The report can be accessed at http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf.

An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements: Auditing Interpretations of AT Section 501

.175 For IDIs, Interpretation No. 1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9501 par. .01–.07), addresses whether the auditor can meet the integrated audit requirement when an IDI does not prepare financial statements for external distribution and, if so, how the auditor can report on the effectiveness of the IDI's internal control over financial reporting.

.176 According to 12 CFR 363, an IDI that is a subsidiary of a holding company may use the consolidated holding company's financial statements to satisfy the audited financial statements requirement of 12 CFR 363, provided that certain criteria are met. For some IDIs, however, an examination of internal control over financial reporting is required at the IDI level.

.177 For IDIs that require an examination of internal control at the IDI level and the IDI does not prepare financial statements for external distribution, the auditor is, nevertheless, required by paragraph .41 of AT section 501 to evaluate the IDI's period-end financial reporting process. This process includes, among other things, the IDI's procedures for preparing financial information for purposes of the consolidated holding company's financial statements, which are prepared in accordance with U.S. GAAP, and the schedules equivalent to the basic financial statements that are included in the IDI's appropriate regulatory report.

.178 The illustrative reports in exhibit A, "Illustrative Reports," of AT section 501 may be used to report on the effectiveness of the IDI's internal control over financial reporting. This interpretation includes an illustrative definition paragraph that may be used when an IDI that is not subject to SOX elects to report on controls for FDICI Act purposes at the IDI level, and the IDI uses the consolidated holding company's financial statements to satisfy the audited financial statements requirement of 12 CFR 363.

.179 The interpretation in its entirety can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/DownloadableDocuments/FINAL_AT9501_Interpret_No_1.pdf.

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PCAOB Auditing Standards on Risk Assessment

.180 In August 2010, the PCAOB adopted a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit. These standards were initially proposed in late 2008 and reproposed in late 2009. These risk assessment standards are intended to benefit investors by setting forth requirements that the PCAOB believes will enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. They apply to audit procedures spanning from the initial planning stages of the audit to the evaluation of the audit results. Changes in the risk assessment standards are intended to enhance integration of the audit of financial statements with the audit of internal control over financial reporting by articulating a process for identifying and assessing risks of material misstatements that apply to both portions of the integrated audit.

.181 The new auditing standards, with a brief description of each, are as follows:

- Auditing Standard No. 8, *Audit Risk*, discusses the auditor's consideration of audit risk in both an integrated audit and an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing it to an appropriately low level.
- Auditing Standard No. 9, *Audit Planning*, establishes requirements for planning an audit, such as assessing important matters and establishing an appropriate audit strategy.
- Auditing Standard No. 10, *Supervision of the Audit Engagement*, applies to the engagement partner and other team members who supervise during the audit. It sets forth requirements for supervision of the audit engagement and the work of other engagement members. Related to this topic, the PCAOB also recently issued a release discussing the SOX provision that authorizes the PCAOB to impose sanctions on registered public accounting firms and their supervisory personnel for failing to reasonably supervise associated persons.
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, establishes requirements regarding the auditor's consideration of materiality in planning and performing an audit.
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements.
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements for responding to the identified risks of material misstatement through appropriate overall audit responses and audit procedures.
- Auditing Standard No. 14, *Evaluating Audit Results*, establishes requirements for evaluating audit results and determining whether sufficient appropriate audit evidence was obtained.
- Auditing Standard No. 15, *Audit Evidence*, discusses what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.

.182 These risk assessment standards will supersede the following six PCAOB interim standards and related amendments: AU section 311, *Planning and Supervision*; AU section 312, *Audit Risk and Materiality in Conducting an Audit*; AU section 313, *Substantive Tests Prior to the Balance Sheet Date*; AU section 319, *Consideration of Internal Control in a Financial Statement Audit*; AU section 326, *Evidential Matter*; and AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). The standards, if approved by the SEC, will be effective for audits of fiscal periods beginning on or after December 15, 2010.

.183 In September 2010, the SEC published *Notice of Filing of Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* to solicit comments on the proposed rules. This notice was posted in the *Federal Register* on September 27, 2010. Comments were due 21 days from the publication of the notice in the *Federal Register*, and the SEC will take action on the proposed rules 90 days from the publication of the notice in the *Federal Register*.

Engagement Quality Review for Issuers

.184 In January 2010, the PCAOB announced that the SEC had approved Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which was adopted by the PCAOB in July 2009. Auditing Standard No. 7 provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. The PCAOB expects Auditing Standard No. 7 to increase the likelihood that a registered public accounting firm will catch any significant engagement deficiencies before it issues its audit report. As a result, more work may be necessary under this standard than performed under the existing requirements for concurring partners. However, Auditing Standard No. 7 explains that the procedures required by the engagement quality reviewer are different in nature than those required to be performed by the engagement team. Further, if the engagement quality reviewer deems more work is required before giving approval of issuance, the engagement team is responsible for completing that work.

.185 This standard applies to all audit engagements, and engagements to review interim financial information, conducted pursuant to the standards of the PCAOB, and it supersedes the PCAOB's interim concurring partner review requirement. Auditing Standard No. 7 is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009. For a calendar-year company, this standard is applicable for the quarter ended March 31, 2010. Subsequent to the issuance of Auditing Standard No. 7, the PCAOB issued Staff Question and Answer, *Auditing Standard No. 7, Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10), to provide further implementation guidance on the documentation requirements of the standard. For the full text of the standard and the question and answer, readers are encouraged to visit the PCAOB's website at www.pcaob.org.

Auditing Fair Value Measurements

.186 In addition to understanding the looming questions relative to accounting for fair value measurements, auditors should be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair value measurements and disclosures to ensure they are in conformity with U.S. GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*).

.187 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable price in an active market. If that is not available, a valuation method should incorporate market-based assumptions that market participants would use in their estimates when that information is available without undue cost and effort. If information about market participant assumptions is not available, management may use its own assumptions, as long as there are no contrary data indicating that market participants would use different assumptions.

.188 The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. When obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the auditor considers, for example

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- controls over the process used to determine fair value measurements.
- the expertise and experience of those persons determining the fair value measurements.
- the extent to which management's process relies on a service organization to provide fair value measurements or the data that supports the measurements.
- the process used to develop and apply management assumptions, including whether management used available market information to develop the assumptions.
- the significant management assumptions used in determining fair values.

.189 According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB ASC 820, this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.
- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)
- The reasonableness of the determination within the fair value hierarchy of inputs.

Fair Values of Securities

.190 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support fair values; however, when quoted market prices are unavailable and the valuations of securities are obtained from a broker-dealer or another pricing service, the auditor should understand the method used by the broker-dealer or pricing service to estimate the fair value measurement (such as a pricing model, a cash flow projection, or other method). These fair value estimates also may be based on quoted prices from an active market for similar securities or other observable inputs or may be based on valuation models that will be a consideration on the auditor's procedures. The auditor should evaluate the methods and assumptions used by the pricing service to estimate fair value to determine whether those methods and assumptions are consistent with the requirements of U.S. GAAP (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the pricing source, which could inhibit objective pricing, and underlying significant valuation assumptions that are highly subjective. In the context of FASB ASC 820, quoted prices in active markets are considered level 1 inputs.

.191 Substantive testing procedures on management's assertions about fair value determined by a model may include the following:

- Assessing the reasonableness and appropriateness of the model
- Assessing the reasonableness and appropriateness of the assumptions used
- Comparing management's assumptions to observable data such as industry reports or benchmarks
- Calculating the value using a model developed by the auditor or a specialist engaged by the auditor to determine an independent expectation to corroborate the reasonableness of the value calculated by the entity
- Comparing the fair value with subsequent or recent transactions

.192 Whether the inputs to the entity's valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB ASC 820-10-35. When extensive judgment is needed, consider using a specialist or refer to AU sections 328 and 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.193 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles.

.194 The auditor also should evaluate management's conclusions regarding other-than-temporary impairment (OTTI) on its equity and debt securities. Examples of factors that could cause OTTI for equity securities, per paragraph .47 of AU section 332, include the following:

- Fair value is significantly below cost and
  - the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - the decline has existed for an extended period of time.
  - management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

.195 Auditors should consider all facts and circumstances when determining if an OTTI has occurred. Additionally, certain securities are required to be classified into categories according to management's intent and ability, such as held to maturity. The auditor should obtain an understanding of management's classification process among trading, available for sale, and held to maturity, as well as consider the classifications in light of the entity's current financial position.

.196 The subsequent section, "Auditing Investment Security Credit Impairment" addresses OTTI for debt securities.

Auditing Investment Security Credit Impairment

.197 FASB issued new guidance in 2009 for determining the amount of impairment to record on debt securities when the decline in a security's value represents OTTI. Prior to the recent guidance, the amount of

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OTTI was determined by writing the security down to fair value through earnings. Under the new guidance, securities with OTTI continue to be written down to fair value through earnings if (*a*) management has the intent to sell or (*b*) it is more likely than not that the company will be required to sell prior to anticipated recovery. If neither of these conditions is true, OTTI instead must be separated into a credit component, which is charged to earnings, and a noncredit component, which is charged to other comprehensive income. Determination of the credit component basically involves forecasting cash flows, discounting those cash flows using the accounting yield, and comparing the present value with the security's carrying amount. The credit component of an OTTI is the excess of the carrying amount over the present value.

.198 Computing the credit component of an OTTI on an investment in a single issuer debt instrument is a rather straightforward analysis and will commonly lead to an all-or-none conclusion. Said differently, if the issuer is expected to fail and the investor is expecting to collect nothing, the entire decline in fair value represents the credit component of an OTTI amount. In contrast, if the issuer is not expected to fail and the investor expects to collect everything it is due, the entire decline in value represents the noncredit component of an OTTI. Other circumstances (for example, the use of probability weighted outcomes or investors agreeing to concessions) will result in both credit and noncredit components.

.199 Computing the credit component of an OTTI for an investment in a securitization is considerably more involved. Referred to as beneficial interests, these securities are backed by the collateral held in a securitization trust. Private label collateralized mortgage obligations (CMOs) and trust-preferred collateralized debt obligation (CDO) are two common examples of investments held by financial institutions for which a complex OTTI calculation may be required. This computation includes the following steps:

- *Cash inflows*. Rather than forecasting the cash flows of a single issuer, cash flows need to be forecasted for the collateral in the trust, which may be as few as 20 or more than 1,000 different assets.
- *Cash outflows*. Once the cash flow assumptions of the underlying collateral have been determined, the next step is to allocate those cash flows to each security class or tranche by period, the process for which is referred to as the cash flow "waterfall." The cash flow "waterfall" computation is based on the legal terms of securitization, which can be found in the prospectus and are often highly complex. Software is available for these computations, but only a limited number of vendors supply it, and the software is typically expensive to obtain.
- *Allocation*. After the cash outflows have been computed for each security class, those cash flows need to be allocated to an investor's ownership of that class. It is important to perform this allocation on an "apples to apples" basis; otherwise, the investor-level cash flows may be overstated or understated.
- *Discounting*. Lastly, the cash flows are discounted using the accounting yield (not coupon) and compared with the carrying amount.

.200 Care should be taken when forecasting and discounting the cash flows when either the underlying collateral or investment securities involve variable rate instruments. The same method with respect to the variable rate index should be used to both forecast and discount cash flows. For example, if the forward curve is used to forecast cash flows, then the same forward curve (or as a practical expedient, the fixed rate equivalent of that curve) should be used as the variable rate index component of the accounting yield for discounting.

.201 The key assumptions to consider in evaluating private label CMOs include the following:

- Voluntary prepayment rate (VPR), which refers to the rate of prepayment for which no loss is expected.
- Default rate (also referred to as constant default rate [CDR]). A default typically leads to foreclosure and sale of the collateral, which is a type of prepayment event. Unlike VPR, a default rate typically has a loss expectation.
- Loss severity upon default.

.202 Note that the combination of VPR and CDR represents the total credit prepayment rate (CPR). Further, some systems have an input field labeled CPR, but for the computation to function correctly, it requires inputting VPR into the CPR field.

.203 The key assumptions to consider in a trust-preferred CDO include the following:

- Specific defaults and default rates
- Interest deferrals and timing
- Recovery rate on deferrals
- Prepayments

.204 Given the complexity of developing assumptions, the cash flow "waterfall," variable rates, and the like, companies will commonly use a third-party expert. Although these computations can be completed in spreadsheets, auditing those spreadsheets against the legal terms of the securitization presents its own challenges such that if the company doesn't engage an expert to perform the computations, the auditor may consider hiring his or her own expert to test the computation.

.205 Other matters to consider include the following:

- Companies should not wait for an event to record OTTI. The determination of the credit component of an OTTI is based on an expected loss model.
- Be sure to seek out and evaluate subsequent events within the underlying collateral when auditing key assumptions.
- Evaluate recurring losses on the same security. Quarter-over-quarter losses suggest a shortcoming in the process of developing assumptions or an error in the mathematical computation.
- Developing assumptions requires the use of judgment. Beyond that, the credit component of an OTTI is primarily a complex mathematical computation.

Auditing Accounting Estimates

.206 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in financial statements. Some examples include the ALL, loan servicing rights, OTTI of securities, impairment analyses and estimated goodwill and other intangibles and useful lives of long-lived assets, valuation allowance for deferred tax assets, uncertain tax positions, and actuarial assumptions in pension and other postretirement benefit costs.

.207 Given the continuing economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, the auditor normally concentrates on key factors and assumptions that are significant to the accounting estimate, sensitive to variations, deviations from historical patterns, or subjective and susceptible to misstatement and bias.

.208 It is important to consider whether historical patterns are still applicable. For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet earnings expectations, the determination of the reasonableness of management's accounting estimates would be made with a heightened level of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

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.209 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. Alternatively, the auditor may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342. The AICPA has released a proposed SAS, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* (Redrafted), on auditing accounting estimates, including fair value. Readers are encouraged to remain alert for developments on this topic.

Using the Work of a Specialist

.210 The auditor may find it necessary to engage a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.

.211 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of the methods and assumptions used by the specialist, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements.

Using the Work of Other Auditors and Engaging Assistance From Outside the Firm

.212 In July 2010, the PCAOB issued Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06), because it observed that a number of registered public accounting firms located in the United States have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the United States. Auditors of issuers should consult this practice alert for reminders concerning their obligations when using the work of other firms or using assistants engaged from outside the firm, such as in the aforementioned situation.

Auditing Troubled Debt Restructurings

.213 Weakness in the housing market and the rise in foreclosures continue to increase the potential for higher levels of loan restructurings resulting from elevated nonperforming loan levels. An audit risk includes not identifying modifications as troubled debt restructurings, thus leading to inaccurate disclosures and potentially understated impairment measures. The *OCC and OTS Mortgage Metrics Report: Disclosure of National Bank and Federal Thrift Mortgage Loan Data* for the second quarter of 2010 contains trends in mortgage modifications for the most recent quarter and provides performance data on first-lien residential mortgages serviced by national banks and federally regulated thrifts. The report can found at www.occ.treas.gov/ftp/release/2010-112.htm.

Auditing Other Real Estate Owned

.214 Another significant risk factor for depository and lending institutions has been the extensive amount of other real estate (ORE) held by depository and lending institutions. Becoming familiar with the current risks related to ORE, along with the applicable accounting guidance, including guidance applicable to transactions by which these assets are sold and potentially derecognized, is important for auditors of depository and lending institutions. Examples of potential audit risks related to these assets include the following:

- Outdated appraisals
- Appraisals in unstable market conditions
- ORE values inflated to hide loan losses
- Ineffective processes for identifying losses

.215 FASB ASC 310-40 applies to initial measurement of a foreclosed property. At the time of foreclosure, foreclosed property should be recorded at fair value less estimated selling costs, establishing a new cost basis (for example, carrying amount). For subsequent measurement, FASB ASC 360-10-35-43 states that a long-lived asset (disposal group) classified as held for sale should be measured at the lower of its carrying amount or fair value less cost to sell.

.216 FASB ASC 360-20 establishes standards for recognition of profit on all real estate sales transactions, other than retail land sales, without regard to the nature of the seller's business. FASB ASC 360-20-40 presents the real estate derecognition guidance primarily from the perspective of the profit recognition upon a sale.

.217 The sale of foreclosed property may be financed by a loan at less than current market interest rates. In addition, depository and lending institutions may facilitate the sale of foreclosed property by requiring little or no down payment or by offering terms extremely favorable to the buyer. The buyer's initial and continuing investments may be inadequate, and recovery of the cost of the property may not be reasonably assured if the buyer defaults. Additionally, the property's cost may have already been recovered, but collections of additional amounts remain uncertain. In these situations, FASB ASC 360-20-40-31 requires the use of the deposit method or the cost recovery method.

.218 Auditors may consider the following when evaluating sales of foreclosed property:

- Whether each disposition and related financing is evaluated by management to determine whether the conditions have been met to record the transaction using a full accrual method
- For each disposition and related financing, the type of property, the composition and amount of the initial investment, whether the initial investment was funded by the buyer or another source of financing, and the percentage of the receivable to the sales price
- Whether the terms of the sale represent an option to buy the property
- Possible factors affecting collectibility of the receivable
- The length of the financing period, the interest rate, and other terms of the financing arrangement

.219 FASB ASC 360-20-55 provides additional guidance regarding the full accrual method, as well as methods of accounting when the criteria for the full accrual method are not met. FASB ASC 360-20-55-21 includes a decision tree that provides an overview of the major provisions in FASB ASC 360-20 and includes the general requirements for recognizing a sale and all of the profit on a sale of real estate at the date of sale.

.220 Auditors may also consider the following related to the recording, measurement, and derecognition of ORE:

- Whether the other assets owned are measured and reported in accordance with the applicable guidance, including FASB ASC 310, *Receivable*; FASB ASC 360-20; and FASB ASC 820

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- Whether the institution has documented written policies and procedures that may include the following:
  - — Frequency of appraisals and selection and qualifications of appraisers
  - — Disbursement of funds and capitalization of costs
  - — Review and monitoring of marketing efforts
  - — Nature and amount of facilitating financing
  - — Costs to sell
  - — Capitalization of interest
  - — Proper authorizations for specific transactions
  - — Estimation of fair value of real estate assets

.221 Estimates of the fair value of real estate assets are necessary to account for such assets. AU section 328 provides guidance on auditing fair value estimates. Many fair values will be based on valuations by independent appraisers. In applying audit procedures to real estate, the auditor often relies on representations of independent experts, particularly appraisers and construction consultants, to assist in the assessment of real estate values. AU section 336, as previously noted, provides guidance regarding using the work of a specialist. When an appraisal is used as audit evidence, the auditor may

- consider the following to evaluate the professional qualifications of the specialist in determining that the specialist possesses the necessary skill or knowledge in the particular field:
  - — The professional certification, license, or other recognition of the competence of the appraiser
  - — The reputation and standing of the appraiser in the views of peers and others familiar with the appraiser's capability or performance
  - — The appraiser's experience with the particular type of real estate collateral being valued
  - — The appraiser's experience with real estate in the specific geographic location of the collateral
- evaluate the objectivity of the appraiser based on any relationships that the appraiser has with the financial institution.
- obtain an understanding of the methods and assumptions used by the appraiser.
- test the data provided to the appraiser.
- evaluate whether the appraiser's findings support the fair value measurement.

Auditing Repurchase Agreements

.222 Certain repurchase agreements (repo), whether viewed from an accounting, legal, or economic perspective, are extremely complex. Also, the risks involved in repo transactions vary widely, depending on the terms of the agreement, the parties involved, and the legal status of the agreement. The risks faced by an institution entering into a repo are generally reduced if the institution maintains effective controls related to the authorization, processing, and recording of these transactions.

.223 When a smaller financial institution sells securities to a larger financial institution under agreements to repurchase, the agreements may have default provisions that would be considered for disclosure in the financial statements. For example, a common default provision applies when the selling financial institution drops below well capitalized under prompt corrective action provisions. The defaulting institution may be required to pay amounts in excess of the outstanding balance plus accrued interest.

.224 Repurchase agreements (including standard Public Securities Association and International Securities Market Association agreements) and other source documents are usually inspected by management and reviewed by auditors to identify events of default provisions. Management would consider whether an event of default has occurred and whether a liability would be required to be recorded as a result. Management may also consider whether the defaulting institution is liable for any additional costs and, if so, whether the additional cost were accrued. Additional costs may include legal expenses and fees, other expenses, and commissions related to entering into replacement transactions or entering into or terminating hedge transactions incurred by the nondefaulting institution. See the "Regulatory Accounting Issues and Developments" section of this alert for additional information related to repos.

Supplementary and Other Information Related to Financial Statements

.225 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.226 SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information. *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

Supplementary Information in Relation to the Financial Statements as a Whole

.227 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of GAAS, *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework.

Required Supplementary Information

.228 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558), addresses the auditor's responsibility with respect to *required supplementary information*. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic

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financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information.

Consideration of an Entity's Ability to Continue as a Going Concern

.229 The consideration of an institution's ability to continue as a going concern is required in every audit performed under GAAS and continues to be an especially important consideration in the current state of the economy. An institution's ability to continue as a going concern is affected by many factors, such as the following:

- The geographic area in which the entity operates
- Credit concentrations in areas such as residential or commercial real estate in particular geographic areas
- The effects of scheduled increases in deposit insurance premiums
- The continued existence of conditions that brought about previous regulatory actions or restrictions
- Exposure to the institution posed by transactions with correspondent banks and related limitations on interbank liabilities
- Noncompliance with laws and regulations
- Supervisory actions or regulatory changes that place limitations or restrictions on operating activities
- The failure to meet minimum regulatory capital requirements
- The classification of the institution under prompt corrective action provisions

.230 As explained by paragraph .02 of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1), the auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at, or have occurred prior to, the date of the auditor's report. Therefore, this is an ongoing evaluation that extends through the date of the auditor's report. AU section 341 notes that this period is not to exceed one year beyond the date of the financial statements being audited. If the auditor believes that a substantial doubt about the entity's ability to continue as a going concern exists, the next steps are to obtain management's plans to mitigate the effect of such conditions and then assess the likelihood that these plans can be implemented effectively.

.231 If, after considering identified conditions and events in the aggregate and after considering management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the auditor should consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time and include an explanatory paragraph in the audit report to reflect this conclusion. The auditor should also communicate the following with those charged with governance:

a. The nature of the events or conditions identified

b. The possible effect on the financial statements and the adequacy of related disclosures in the financial statements

c. The effects on the auditor's report

.232 Alternatively, if management's plan mitigates the risk of the entity's inability to continue as a going concern, the auditor should consider the need for management to disclose the primary conditions that gave rise to the initial doubt and management's plans. These disclosures are especially important for financial statement users to fully comprehend the entity's financial strength and ability to continue as a going concern.

.233 When, after considering management's plans, the auditor concludes there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, the auditor should consider the possible effects on the financial statements and the adequacy of the related disclosure. Some of the information that might be disclosed includes the following:

- Pertinent conditions and events giving rise to the assessment of substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time
- The possible effects of such conditions and events
- Management's evaluation of the significance of those conditions and events and any mitigating factors
- Possible discontinuance of operations
- Management's plans (including relevant prospective financial information)
- Information about the recoverability or classification of recorded asset amounts or the amounts or classification of liabilities

.234 Paragraph .14 of AU section 341 states that if the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from GAAP exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1).

.235 FASB has undertaken a project that will incorporate going concern guidance into accounting literature. One of the expected major changes is the going concern time frame. See the "Going Concern" section of this alert for more information.

Service Organizations

.236 Since 1992, SAS No. 70 has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. SSAE No. 16 contains the requirements for reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, and earlier implementation is permitted. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324. Once the new SAS becomes effective, it will replace the guidance for user auditors currently in AU section 324. SSAE No. 16 is based on the International Auditing and Assurance Standards Board's (IAASB's) International Standard on Assurance Engagements No. 3402, *Assurance Reports on Controls at a Service Organization*, and the new SAS is based on the IAASB's International Standard on Auditing (ISA) 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

.237 The AICPA is in the process of overhauling and rewriting the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (commonly known as the SAS 70 guide). Also, to address reporting on a service provider's controls over subject matter other than financial reporting, the AICPA is developing the new Audit Guide *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*. Both guides are expected to be available for sale in early 2011. The AICPA is also in the process of drafting communication materials that will help auditors, clients, and users understand the three types of service organization control (SOC) reports (formerly SAS No. 70 reports) to be used for reporting on these engagements.

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	Title	Description
SOC 1	*Report on Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting*	To be used only in circumstances when the service organization's services and controls affect the internal control over financial reporting for the entities that use the service. These reports are not general use reports and cannot be freely distributed.
SOC 2	*Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, and Privacy*	The purpose is to convey trust and assurance to users of the system that the service organization has deployed an effective control system to effectively mitigate operational and compliance risks that the system may represent to its users. These reports are not general use reports and can be only be distributed at the discretion of the auditor.
SOC 3	*Trust Services Report*	These reports are designed to meet the needs of users who want assurance on the controls at a service organization related to the security, availability, processing integrity, confidentiality, or privacy of a system but do not have the need for the level of detail provided in an SOC 2 report. These reports are general use reports and can be freely distributed or posted on a website as a seal.

Compilation and Review Engagements

.238 The AICPA developed a new guide, *Compilation and Review Engagements*, which provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

FASB Accounting Issues and Developments

.239 Given the current economic climate, auditors should consider a number of accounting and financial reporting issues. This section addresses recent guidance issued by FASB in response the current environment, such as the following:

- Disclosures about the credit quality of financing receivables and the allowance for credit losses
- Fair value, including fair value measurements in illiquid markets
- Impairment

.240 In addition, recently effective FASB guidance, including ASU Nos. 2009-16 and 2009-17, has had a major effect on certain institutions' balance sheets and income statements, beginning with the first quarter of 2010 for calendar year-end companies.

FASB ASC and the Hierarchy of GAAP

.241 FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, as codified in FASB ASC 105, Generally Accepted Accounting Principles, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to

guidance issued by the SEC. FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in their financial statements.

.242 The FASB Notice to Constituents includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*." Conversely, FASB suggests using the detailed numerical referencing system in working papers, articles, textbooks, and related items.

.243 Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/FASBAccountingStandardsCodification.aspx.

Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses

.244 In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. For many depository and lending institutions, this guidance may require institutions to modify the manner in which the financing receivables are identified and monitored. In addition, these requirements may necessitate the need for changes in systems, policies, and procedures used to collect information on financing receivables.

.245 The ASU amends the existing disclosures to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis:

- A rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method.
- For each disaggregated ending balance, the related recorded investment in financing receivables should also be disclosed.
- The nonaccrual status of financing receivables by class of financing receivables.
- Impaired financing receivables by class of financing receivables.

.246 The ASU defines two levels of disaggregation: portfolio segment and class of financing receivable. A *portfolio segment* is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. *Classes of financing receivables* generally are a disaggregation of portfolio segment.

.247 The amendments in this ASU require an entity to provide the following additional disclosures about its financing receivables:

- Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables (see FASB ASC 310-10-55-19 for examples of credit quality indicators)
- The aging of past due financing receivables at the end of the reporting period by class of financing receivables

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- The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment.

.248 An entity must also describe, by portfolio segment, its accounting policies and methodology used to estimate its allowance for credit losses, including the identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

.249 The amendments in this ASU apply to all entities with financing receivables. Examples of financing receivables include loans, trade receivables greater than one year, notes receivable, and receivables relating to a lessors' leveraged, direct financing, and sales-type leases. The new disclosure requirements do not affect short-term trade accounts receivable, receivables that are measured at fair value or the lower of cost or fair value, and debt securities. See the "Pending Content" in paragraphs 13–15 of FASB ASC 310-10-55 for more information on the definition of *financing receivable*, including a full list of items that are excluded from the definition. In addition, the "Pending Content" in paragraphs 7–12 of FASB ASC 310-10-55 illustrates certain disclosures required by this ASU.

.250 For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010.

.251 For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

Consolidation of Variable Interest Entities

.252 For calendar year entities, 2010 is the first year of application of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB Statement No. 167 was incorporated into FASB ASC through ASU No. 2009-17. This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited.

.253 ASU No. 2009-17 retains the scope of previous variable interest entity (VIE) consolidation accounting guidance (with some modifications), with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, which was incorporated into FASB ASC by ASU No. 2009-16.

.254 ASU No. 2009-17 amended the consolidation of VIE guidance in FASB ASC 810-10 to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE and replaced it with an analysis of both of the following characteristics:

- The power to direct the activities of a VIE that most significantly impacts the entity's economic performance
- The obligation to absorb losses of the entity that could potentially be significant to the VIE or the right to receive benefits from the entity that could potentially be significant to the VIE

.255 ASU No. 2009-17 also makes the following amendments to FASB ASC 810-10:

- Amends certain guidance for determining whether an entity is a VIE.
- Adds an additional reconsideration event for determining whether an entity is a VIE when any changes in facts and circumstances occur such that the holders of the equity investment at risk, as a group, lose the power from voting or similar rights of those investments to direct the activities of the entity that most significantly impact the entity's economic performance.
- Eliminates the exception of a troubled debt restructuring not being an event that would require reconsideration of whether an entity is a VIE or whether an enterprise is the primary beneficiary of a VIE.
- Requires an ongoing reassessment of whether an enterprise is the primary beneficiary of a VIE.
- Requires additional disclosures about involvement with VIEs and any significant changes in risk exposure due to that involvement. Entities also will be required to disclose how involvement with a VIE affects the entity's financial statements.

.256 ASU No. 2009-17 also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a VIE or disclose information about its involvement in a VIE, or both
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks associated with an enterprise's involvement with the VIE
- How an enterprise's involvement with the VIE affects the enterprise's financial position, financial performance, and cash flows

.257 ASU No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*, was issued in February 2010 to defer the consolidation requirements contained in ASU No. 2009-17 for a reporting entity's interest in certain investment funds, so that FASB and the International Accounting Standards Board (IASB) could develop consistent guidance on principal and agent relationships as part of their joint consolidation project. The deferral applies to a reporting entity's interest in an entity that has all the attributes of an investment company or for which it is industry practice to apply measurement principles, for financial reporting purposes, that are consistent with those followed by investment companies. An entity that qualifies for the deferral will continue to be assessed under the overall guidance on the consolidation of VIEs in FASB ASC 810-10, ASU No. 2009-17 amendments, or other applicable consolidation guidance.

.258 ASU No. 2010-10 does not defer the disclosure requirements from ASU No. 2009-17. The effective date of this guidance coincides with the effective date of ASU No. 2009-17 (the beginning of a reporting entity's first annual period that begins after November 15, 2009, and for interim periods).

Accounting for Transfers of Financial Assets

.259 Effective on January 1, 2010, calendar-year entities were required to apply the provisions of FASB Statement No. 166, which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*. FASB Statement No. 166 was incorporated into FASB ASC by ASU No. 2009-16 and is discussed in FASB ASC 860, *Transfers and Servicing*. The amendments made by ASU No. 2009-16 were effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. The recognition and measurement amendments must be applied to transfers (advances) occurring on or after the effective date, regardless if they were made pursuant to a loan participation agreement in place

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prior to the effective date. Additionally, on and after the effective date, all existing qualifying special purpose entities must be evaluated for consolidation in accordance with the applicable consolidation literature. The disclosure provisions should be applied to transfers that occurred both before and after the effective date.[8]

.260 The following highlights the amendments made by ASU No. 2009-16 to FASB ASC 860 and includes auditor considerations in evaluating management's application of the amendments:

- Eliminates the concept of a qualifying special purpose entity and the exception to the consolidation of a qualifying special purpose entity. An auditor should evaluate management's conclusions about whether a formerly qualifying special purpose entity should be consolidated or whether adequate disclosures have been made in accordance with the amended disclosure requirements in FASB ASC 810, *Consolidation*, and FASB ASC 860.
- Modifies the financial components approach to specify when a portion of a financial asset would be eligible to be evaluated for derecognition under FASB ASC 860-10-40-5. Such transferred portions must meet the definition of a *participating interest*, as described in FASB ASC 860-10-40-6A, and under that definition, some common transfers would be affected. For example, last-in, first-out loan participations[9] would no longer be eligible for sale accounting, and sale accounting for the transferred portion of Small Business Administration loans would be delayed.[10] An auditor should carefully evaluate transfers made pursuant to a loan participation agreement and other transfers of portions.
- Clarifies and amends the conditions for sale accounting in FASB ASC 860-10-40-5. In evaluating management's application of those amended conditions, an auditor should evaluate whether management's evaluation considered the following:
  - All arrangements or agreements made contemporaneously with, or in contemplation of, a transfer, even if not entered into at the time of the transfer.
  - The transferor's continuing involvement with the transferred financial assets.
  - The transferor, its consolidated affiliates included in the financial statements being presented, and its creditors in applying the isolation condition in FASB ASC 860-10-40-5(a).
  - Other forms of effective control, in addition to the examples provided in FASB ASC 860-10-40-5(c). That paragraph has been amended to be a principle, with the previous criterion being clarified to indicate that they are only examples of effective control.
- Eliminates the special considerations for guaranteed mortgage securitizations. As a result, an auditor should evaluate whether such transfers meet the same requirements for derecognition as other transfers of financial assets.
- Requires that a transferor recognize and initially measure at fair value all assets obtained (including a transferor's beneficial interest) and liabilities incurred as a result of a transfer of an entire financial asset or group of entire financial assets accounted for as a sale. An auditor should evaluate management's determination of fair value in accordance with FASB ASC 820, including the required disclosures in FASB ASC 860-20-50-3 about such initial fair value measurement.

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[8] The OCC, the Federal Reserve, the FDIC, and the OTS amended their general risk-based and advanced risk-based capital adequacy frameworks, providing an optional two-quarter implementation delay followed by an optional two-quarter partial implementation of the effect on risk-weighted assets resulting from amendments from Financial Accounting Standards Board (FASB) Accounting Standards Update No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*, and No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. See the final rule at www.occ.treas.gov/fr/fedregister/75fr4636.pdf for additional information.

[9] Under amended FASB *Accounting Standards Codification* 860, *Transfers and Servicing*, so-called last-in, first-out (LIFO) participations in which all principal cash flows collected on the loan are paid first to the party acquiring the participation do not meet the definition of a *participating interest*. Similarly, so-called first-in, first-out (FIFO) participations in which all principal cash flows collected on the loan are paid first to the lead lender do not meet the definition of a *participating interest*. As a result, neither LIFO nor FIFO participations transferred on or after the beginning of a bank's first annual reporting period that begins after November 15, 2009 (for example, January 1, 2010, for a bank with a calendar-year fiscal year), will qualify for sale accounting and, instead, must be reported as secured borrowings. See the Federal Financial Institutions Examination Council (FFIEC) *Instructions for Preparation of Consolidated Reports of Condition and Income* at www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_FFIEC041_201009_i.pdf for additional information.

[10] FFIEC Call Report instructions also address the application of the *participating interest* definition to Small Business Administration loans.

- Provides four disclosure objectives and requires additional specific disclosures about transfers of financial assets in which an entity has continuing involvement with the transferred financial assets. An auditor should evaluate whether the four disclosure objectives have been met for all transfers of financial assets, including loan participations and securitizations. Those objectives must be met regardless of the specific disclosure requirements for certain transfers of financial assets, and an entity may need to supplement the required disclosures in order to meet the disclosure objective. For example, a transferor in a loan participation may need to supplement the required disclosures in order to meet the disclosure objectives because there are no specific disclosures required for loan participations.

.261 Interpretation No. 1, "The Use of Legal Interpretations As Audit Evidence to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraphs 7–14 of Financial Accounting Standards Board *Accounting Standards Codification* 860-10-40," of AU section 336 (AICPA, *Professional Standards*, AU sec. 9336 par. .01–.21), provides guidance to the auditor in obtaining sufficient appropriate audit evidence when an entity has derecognized financial assets in connection with a transfer to another entity. In light of the issuance of ASU No. 2009-16, the ASB is currently in the process of revising this guidance. Auditors should be alert for such revisions; however, the guidance in Interpretation No. 1 continues to be relevant.

.262 The Center for Audit Quality (CAQ) has created a resource related to FASB Statement Nos. 166 and 167 on its website to provide readers with relevant information from a variety of sources, including guidance from standard setters, publications by the CAQ and member firms, and webcasts. This information can be found at www.thecaq.org/resources/aftabackground.htm.

Decreases in Ownership of a Subsidiary

.263 In January 2010, FASB issued ASU No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*. This ASU addresses implementation issues related to the changes in ownership provisions in FASB ASC 810-10 (issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*). These amendments clarify that the scope of the decrease in ownership provisions of FASB ASC 810-10 and related guidance applies to a subsidiary or group of assets that is a business or nonprofit activity, a subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture, and an exchange of a group of assets that constitutes a business or nonprofit activity for a noncontrolling interest in an entity (including an equity method investee or joint venture). Further, the amendments clarify that the decrease in ownership guidance in FASB ASC 810-10 does not apply to sales of in-substance real estate or conveyances of oil and gas mineral rights, even if they involve businesses (for guidance on a sale of in substance real estate, see FASB ASC 360-20 or FASB ASC 976-605). The amendment also expands the required disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of FASB ASC 810-10. This ASU is effective beginning in the period that an entity adopts FASB Statement No. 160, which was codified in FASB ASC 810. If an entity has already adopted this guidance, then the amendments in this ASU are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this ASU should be applied retrospectively to the first period that an entity adopted FASB Statement No. 160.

Accounting for Uncertainty in Income Taxes

.264 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities, and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for

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as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.

- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FASB ASC 740-10-50-15[a]–[b]).

.265 For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009.

Subsequent Events

.266 FASB Statement No. 165, *Subsequent Events*, which has been codified in FASB ASC 855, *Subsequent Events*, is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued). The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

.267 In particular, this statement sets forth the following:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

.268 FASB states that this guidance should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. In September 2009, the AICPA issued TIS section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), which notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. This question and answer can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

.269 In February 2010, FASB issued ASU No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, to address questions that arose in practice about potential conflicts between FASB ASC 855 and SEC guidance—specifically, the requirements to disclose the date that the financial statements are issued. This ASU also addresses the intended breadth of the reissuance disclosure provision related to subsequent events.

.270 ASU No. 2010-09 requires an entity that is an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market to evaluate subsequent events through the date the financial

statements are issued. All other entities must evaluate subsequent events through the date the financial statements are available to be issued. Further, an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. Lastly, only non-SEC filers are required to disclose in the revised financial statements the dates through which subsequent events have been evaluated in both the issued or available-to-be-issued financial statements and the revised financial statements. Revised financial statements are considered reissued financial statements.

.271 The amendments in ASU No. 2010-09 are effective upon issuance, except for the use of the issued date for conduit bond obligors. That amendment is effective for interim or annual periods ending after June 15, 2010. In June 2010, the AICPA issued TIS section 8700.03, "Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor" (AICPA, *Technical Practice Aids*), to provide guidance related to the effect of this ASU on the auditor's responsibilities for subsequent events relative to a conduit debt obligor and the date of the auditor's report.

Fair Value

.272 FASB ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. *Fair value* is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The need to understand fair value accounting has increased in importance due to the changing economic and regulatory environment and the continued emphasis on financial reporting issues related to the needs of the users of financial statements.

Measuring Liabilities at Fair Value

.273 FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value*, to increase the consistency in the application of FASB ASC 820 to liabilities. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after its issuance in August 2009. The full text of the ASU can be accessed from FASB's website at www.fasb.org.

Investments in Certain Entities That Calculate NAV per Share (or its Equivalent)

.274 FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both:

- does not have a *readily determinable fair value*. The FASB ASC glossary states that an equity security has a readily determinable fair value if it meets any of the following conditions:
  - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year. (However, FASB ASC 820 observes that the valuation of a restricted security should be adjusted for the effect of the restriction, even if that restriction terminates within one year.)
  - The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.
  - The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

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- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes is not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies.*

.275 These amendments are effective for interim and annual periods ending after December 15, 2009 and are included in FASB ASC 820-10. An AICPA practice aid, *Alternative Investments—Audit Considerations* also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments.

.276 In December 2009, the AICPA issued sections .18–.27 of TIS section 2220, *Long-Term Investments* (AICPA, *Technical Practice Aids*), to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers compliment the guidance provided in ASU No. 2009-12.

.277 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurements Disclosures

.278 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers among the three levels and the underlying reasons for such transfers would be useful to financial statement users.

.279 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.280 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities. In determining the appropriate classes for fair value measurement disclosures, the reporting entity should consider the level of disaggregated information required for specific assets and liabilities under other topics.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.281 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Convergence With IFRSs

.282 Since the signing of the Norwalk Agreement by FASB and the IASB, the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and IFRSs and eliminate the differences between them. In the Norwalk agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

Regulatory Accounting Issues and Developments

Bargain Purchases and Assisted Acquisitions

.283 On June 7, 2010, federal financial institution regulators issued *Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions* (interagency guidance) to address supervisory considerations related to bargain purchase gains and the impact such gains have on the application (licensing) approval process. This guidance also highlights the accounting and reporting requirements unique to business combinations resulting in bargain purchase gains and FDIC- and NCUA-assisted acquisitions of failed institutions. Although this guidance principally focuses on bargain purchase gains, it is also relevant to business combinations in general.

.284 The recent financial crisis has led to an increase in bargain purchases, particularly those involving FDIC or NCUA assistance. In assisted acquisitions, the FDIC or the NCUA effectively administers an auction for certain assets and liabilities of a failing institution. In the FDIC's case, as part of the acquisition, the FDIC frequently enters into a loss-sharing agreement (LSA) with the acquirer that indemnifies the acquirer for certain losses incurred on assets covered under the agreement (covered assets).

.285 An acquiring institution should apply the acquisition method of accounting to the acquisition of failed banks and credit unions, in accordance with FASB ASC 805, *Business Combinations*, which requires that the assets acquired and liabilities assumed constitute a business. Accordingly, the acquiring institution should recognize and measure at fair value the identifiable assets acquired and the liabilities assumed at the acquisition date. The application of the acquisition method may result in the acquirer recognizing an indemnification asset or a derivative resulting from an LSA with the FDIC. The acquiring institution should then recognize and measure either goodwill or a bargain purchase gain. In general, a bargain purchase occurs when the fair value of the net assets acquired in a business combination exceeds the fair value of the consideration transferred by the acquiring institution. For combinations of mutual institutions in which no consideration is transferred, a bargain purchase occurs when the fair value of the net assets acquired exceeds the fair value of the equity or member interests in the acquiree. This excess, previously referred to as negative goodwill, should be recognized immediately as a gain in earnings (bargain purchase gain).

.286 The interagency guidance discusses supervisory considerations, such as compliance with U.S. GAAP and regulatory reporting requirements, and fair value measurements. The interagency guidance also includes application (licensing) considerations, such as business combination applications to federal and state regulators, and conditions that may be imposed in approvals (for example, regulators may require capital preservation, independent audits, agreed-upon procedures engagements, or independent valuations). Appendixes to the interagency guidance include selected accounting consideration for business combinations and regulatory reporting requirements for business combinations. (See www.fdic.gov/news/news/financial/2010/fil10030a.pdf for the interagency guidance in its entirety.)

.287 In addition, the FDIC's *Supervisory Insights* from summer 2010 includes the article "FDIC Loss-Sharing Agreements: A Primer," which discusses the key supervisory considerations for LSAs. The considerations addressed include a summary of typical LSA structures, an overview of examination procedures for reviewing

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assets covered by LSAs, important accounting and loan loss allowance issues, capital implications from bargain-purchase accounting, and guidelines for establishing adverse classifications. Given the complex nature of accounting for LSAs, the article encourages acquiring institutions to consult with their accountants to ensure that initial and ongoing entries are measured and recorded properly. In addition, examiners may wish to contact internal regulatory accounting resources for support, particularly if significant accounting issues are evident. (See www.fdic.gov/regulations/examinations/supervisory/insights/sisum10/SI_sum10.pdf for the entire text of this article.)

.288 In addition, chapter 3, "Purchase and Assumption Transactions," of the FDIC's *Resolutions Handbook* (handbook) requires that "[w]ithin 90 days after each calendar year end, the acquiring bank must furnish the FDIC a report signed by its independent public accountants containing specified statements relative to the accuracy of any computations made regarding shared loss assets." The term *specified statements* is not defined in the handbook. The practitioner is advised to read the terms of the LSA and confirm that the audit requirement in that agreement provides for the receipt of a report expressing negative assurance.

.289 TIS section 9110.16, "Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions" (AICPA, *Technical Practice Aids*), provides examples of how the auditor might respond. The question and answer suggests that the auditor may respond by issuing a report following the guidance in paragraphs .19–.21 of AU section 623, *Special Reports* (AICPA, *Professional Standards*, vol. 1), and also provides illustrative auditor reports for three possible outcomes for which the auditor might report. The question and answer was issued in February 2010 and can be accessed on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/DownloadableDocuments/TIS_9110_16.pdf. See the "Subsequent Measurement of Credit-Impaired Loans in Business Combinations and Asset Purchases" section in this alert for additional information regarding subsequent measurement issues.

NCUA's Merger and Purchase and Assumption Process

.290 In July 2010, the NCUA issued Letter to Credit Unions 10-CU-11, *Information on NCUA's Merger and Purchase & Assumption Process*. This letter and appendix provide information on the NCUA's merger and purchase and assumption (P&A) process. In an effort to improve transparency, this letter addresses several topics involving mergers and P&As, including the following:

- An explanation of the P&A process and the various types of mergers
- The criteria used to evaluate mergers and P&As
- The identification of merger and P&A partners
- The selection of an acquirer in the limited circumstances when the NCUA is involved in making the choice

.291 The appendix to this letter provides additional information regarding the various types of mergers. Readers can find the entire text of this letter at www.ncua.gov/letters/2010/CU/10-CU-11.pdf.

Subsequent Measurement of Credit-Impaired Loans in Business Combinations and Asset Purchases

.292 The AICPA Depository Institutions Expert Panel (DIEP) provided a confirmation letter to the SEC's Office of the Chief Accountant summarizing its understanding of the SEC staff's view of how discounts related to loan receivables acquired in a business combination or asset purchase should be accreted into earnings. The letter indicates that two divergent views have developed regarding loans that are not required to be accounted for in accordance with the guidance in FASB ASC 310-30 but have the following three characteristics: (*a*) the loans are acquired in a business combination or asset purchase; (*b*) the loans result in the recognition of a discount attributable, at least in part, to credit quality; and (*c*) the loans are not subsequently accounted for at fair value. The letter documents the DIEP's understanding that the SEC staff would not object to an accounting policy based on contractual cash flows, as described in the guidance for accounting for loan origination fees and costs that is included in FASB ASC 310-20, or an accounting policy based on expected cash

flows, as described in the guidance for accounting for loans acquired in a transfer that have deteriorated in credit quality since origination that is included in FASB ASC 310-30. An entity should disclose its accounting policy election and apply that accounting policy consistently. Potential acquirers should be alert for any updated authoritative guidance related to this topic. The letter in its entirety can be found on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgAdvocacy/DownloadableDocuments/Confirmation-letter-on-Day-2.pdf.

Prudent Commercial Real Estate Loan Workouts

.293 In October 2009, the FDIC issued FIL-61-2009, *Policy Statement on Prudent Commercial Real Estate Loan Workouts*, which provides guidance for examiners and financial institutions that are working with commercial real estate borrowers who are experiencing diminished operating cash flows, depreciated collateral values, or prolonged delays in selling or renting commercial properties. This policy statement details risk-management practices for loan workouts that support prudent and pragmatic credit and business decision making within the framework of accurate regulatory reporting, transparency, and timely loss recognition.

.294 The policy statement notes that as the primary sources of loan repayment decline, the importance of the collateral's value as a secondary repayment source increases in analyzing credit risk and developing an appropriate workout plan. The institution should have policies and procedures that dictate when collateral valuations should be updated as part of its ongoing credit review, as market conditions change, or as a borrower's financial condition deteriorates. The policy statement provides additional guidance for both institutions and examiners with respect to compliance with regulatory reporting and accounting requirements, specifically addressing (*a*) implications for interest accrual, (*b*) restructured loans, and (*c*) allowance for loan and lease losses reporting requirements. The following provides a summary of this guidance.

Interest Accrual

.295 For a restructured loan that is not already in nonaccrual status before the restructuring, the institution needs to consider whether the loan should be placed in nonaccrual status. A loan that has been restructured so as to be reasonably assured of repayment and performance need not be maintained in nonaccrual status, provided that the restructuring and any charge-off taken on the loan are supported by a current, well-documented credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must be designated as nonaccrual.

.296 The assessment of accrual status should include consideration of the borrower's sustained historical repayment performance for a reasonable period prior and subsequent to the date of the restructuring. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. For more detailed criteria about placing a loan in nonaccrual status and returning a nonaccrual loan to accrual status, see the FFIEC Call Reports, Thrift Financial Report (TFR), and NCUA 5300 Call Report instructions.

Restructured Loans

.297 The restructuring of a loan or other debt instrument should be undertaken in ways that improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. All restructured loans should be evaluated to determine whether the loan should be reported as a troubled debt restructuring. For reporting purposes, a restructured loan is considered a troubled debt restructuring when the institution, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower in modifying or renewing a loan that the institution would not otherwise consider.

.298 To determine whether a restructured loan is a troubled debt restructuring, the lender assesses whether (*a*) the borrower is experiencing financial difficulties and (*b*) the lender has granted a concession. This determination requires consideration of all the facts and circumstances surrounding the modification. An overall general decline in the economy or some deterioration in a borrower's financial condition does not

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automatically mean that the borrower is experiencing financial difficulties. Accordingly, lenders and examiners should use judgment in evaluating whether a modification is a troubled debt restructuring. Readers can refer to FASB ASC 310-40, which addresses troubled debt restructurings by creditors.

.299 Guidance on reporting troubled debt restructurings, including characteristics of modifications, is included in the FFIEC Call Reports, TFR, and NCUA 5300 Call Report instructions. See also the "FASB Accounting Pipeline" section of this alert for additional information regarding FASB's project on troubled debt restructuring.

Allowance for Loan and Lease Losses

.300 Guidance for the institution's estimate of loan losses and examiners' responsibilities to evaluate these estimates is presented in the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (December 2006) and FDIC FIL-63-2001, *Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Association*. All loans that are reported as troubled debt restructurings are deemed to be impaired and should generally be evaluated on an individual loan basis for the duration of the loan, in accordance with FASB ASC 310-40 and paragraphs 2–30 of FASB ASC 310-10-35.

.301 For an individually evaluated impaired collateral dependent loan, regulatory guidance requires that any recorded amount of the loan that exceeds the fair value of the collateral (less costs to sell if the costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan) that is deemed uncollectible be charged off in a timely manner. However, some or all of this difference may represent a confirmed loss, which should be charged against the allowance for loan and lease loss in a timely manner. Institutions also should consider the need to recognize an allowance for estimated credit losses on off-balance sheet credit exposures, such as loan commitments, in other liabilities, consistent with paragraphs 1–3 of FASB ASC 825-10-35.

Additional Guidance

.302 The attachments to *Policy Statement on Prudent Commercial Real Estate Loan Workouts* (policy statement) include a summary of references to relevant supervisory guidance and authoritative accounting guidance from FASB ASC for real estate lending; appraisals; allowance for loan and lease losses; restructured loans; fair value measurement; and regulatory reporting matters, such as nonaccrual status. The attachments also provide more detailed information about determining whether a borrower is experiencing financial difficulties and the attributes of a concession.

.303 In addition, on December 3, 2009, representatives from the FDIC, the Federal Reserve, the OCC, and the OTS provided an overview of the policy statement and responded to participants' questions regarding its application in a telephone seminar. The transcript to the seminar can be found at www.fdic.gov/news/news/financial/2009/fil09068a2.html. The policy in its entirety can be found at www.fdic.gov/news/news/financial/2009/fil09061a1.pdf.

.304 In June 2010, the NCUA issued Letter to Credit Unions 10-CU-07, *Interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts*, which references the previously mentioned policy statement. Letter to Credit Unions 10-CU-07 adds that loan loss estimates for credit unions should comply with the following:

- U.S. GAAP
- Interpretive Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions*
- Accounting Bulletin 06-1 (December 2006) Interagency Advisory addressing the allowance for loan and lease losses that reiterates key concepts and requirements, including U.S. GAAP and the existing allowance for loan and lease losses supervisory guidance

.305 The letter to credit unions is available at www.ncua.gov/letters/2010/CU/10-CU-07.pdf and the policy statement is available at www.ncua.gov/letters/2010/CU/10-CU-07%20attachment.pdf.

SEC Comment Letters

.306 As discussed in the May 2010 issue of *CFO* magazine, a list of the top 10 concerns of the SEC related to U.S. entities' annual and quarterly filings dated between January 1, 2009, and January 1, 2010, was compiled for all industries. The data was based upon a comment letter database, as of March 24, 2010, compiled by the research firm Audit Analytics. In general, the topics commented on by the SEC remain consistent over the years. The most commented area in filings is the "Management's Discussion & Analysis" section, which provides an overview of the period's operations, how the entity performed, and management's approach to the coming year. It also discusses the fundamentals of the entity, which include members of management and their management style. Typically, the SEC requests more details in entities' descriptions of their operating results, their liquidity and capital resources, and how they develop critical accounting estimates. The next two most commented areas include executive compensation and fair value measurements, which given the economic climate, is not unexpected. The SEC also continues to remain interested in incentive-pay performance targets, such as earnings per share. The remaining seven top general concerns of the SEC are intangible assets and goodwill; disclosure controls; segment reporting; non-GAAP measures; revenue recognition; debt, warrants, and equity issues; and related-party transactions.

.307 In a speech given in September 2010 at the AICPA National Conference on Banks and Savings Institutions, John P. Nolan, senior assistant chief accountant, and Stephanie Hunsaker, associate chief accountant of the SEC, outlined specific areas of frequent SEC staff comment for financial institutions. These areas of frequent comment included the following:

- Asset quality issues, including commercial real estate, appraisals, troubled debt restructurings, and nonimpaired loan allowance
- Securities impairment and goodwill impairment
- ASU Nos. 2009-16 and 2009-17 implementation issues
- Accounting issues related to FDIC-assisted transactions
- Liquidity and risk management

.308 As noted in the speech, the SEC is likely to request enhanced disclosure when a financial institution does not provide sufficient disclosure to explain the circumstances surrounding large fluctuations in charge-offs or nonperforming commercial real estate loans. Entities that experience a significant increase in commercial real estate charge-offs might consider enhancing the disclosure surrounding how the trend of increasing charge-offs has affected or is expected to affect the allowance. For example, entities may consider disclosing the affected triggering events when an ALL is established, how the increasing level of charge-offs is factored in the determination of the different components of the allowance, and how the entities define *confirmed loss* for charge-off purposes and how that affects the level of the ALL.

.309 Also, the entities that are experiencing the following may consider enhanced disclosures:

- Increasing nonperforming loans.
- Commercial real estate workouts whereby an existing loan was restructured into multiple loans.
- Construction or commercial loans that have been extended at maturity, which are not considered to be impaired due to the existence of guarantees.
- A significant amount of loans are measured for impairment based on the collateral values.
- Material amounts of troubled debt restructurings that continue to accrue interest.
- Material amount of modifications not accounted for as troubled debt restructurings.

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.310 Regulatory enforcement actions continue to increase as a result of the economy and elevated regulatory requirements. Enforcement actions may include informal actions, such as the adoption of a board resolution, or formal actions through a consent order or formal agreement.

.311 In 2009, an SEC's presentation addressed formal agreements and indicated that entities should disclose the following, if applicable:

- Summary of all provisions
- Steps taken or expected to be taken to comply with each provision
- Current compliance with each provision
- Material effect on future operations
- Potential consequences of a failure to comply

.312 Memorandums of understanding or informal agreement are not required to be disclosed if prohibited by banking regulations. Institutions and auditors should consult with their primary regulator prior to disclosing information associated with informal regulatory actions. However, if the agreements have a material impact on future operations, entities must disclose actions taken or expected to be taken to comply with the provision. For additional information regarding the areas of frequent comment on financial institutions from SEC staff in 2009, see the slide presentation at www.sec.gov/news/speech/2009/slides1209slh.pdf.

Repurchase Agreement CFO Letter

.313 In March 2010, the SEC's Division of Corporation Finance sent letters to certain public companies requesting information about repurchase agreements, securities lending transactions, or other transactions involving the transfer of financial assets with an obligation to repurchase the transferred assets. Each company was asked to explain the extent to which, if any, they used repurchase agreements and how they accounted for them in their financial statements. In his testimony before the House Committee on Financial Services, on May 21, 2010, James Kroeker, chief accountant of the SEC, stated that based on the requests, no information had come to the division's attention that would lead the staff to conclude that inappropriate practices were widespread. Nevertheless, following the SEC's evaluation of the responses, the SEC asked several companies to enhance their disclosure about their accounting for repurchase agreements and similar transactions and to expand their discussions of off-balance sheet arrangements in their quarterly reports for March 31, 2010.

Loss Contingency Disclosures

.314 The SEC is also focused on the adequacy of loss contingency disclosures in the financial statements of registrants, particularly regarding litigation. The SEC staff has expressed concern about the lack of timely and transparent disclosures. Further, registrants sometimes fail to disclose the amount or range of possible loss when no amount is accrued because the loss is only reasonably possible (rather than probable). Disclosures on contingencies should be specific rather than generic. FASB ASC 450-20-50 discusses disclosures for loss contingencies and explains that in some circumstances, it may be misleading not to disclose the amount accrued in the financial statements for a loss contingency. If an exposure to loss exists in excess of amounts accrued and it is reasonably possible that a loss or additional loss may have been incurred, the estimated possible loss or range of loss or a statement that such estimate cannot be made should be included in the disclosures. The SEC has also questioned the following inconsistency: registrants disclose in the footnotes that the outcome of a contingency is not expected to materially affect their financial statements but explain in the "Risk Factors" section that the same contingency's outcome could materially affect their financial results.

.315 Discussion from the SEC on contingencies can be found in the Division of Corporate Finance's *Current Accounting and Disclosure Issues in the Division of Corporate Finance*, which can be accessed at www.sec.gov/divisions/corpfin/cfacctdisclosureissues.pdf. FASB also has a project on its agenda to revise the guidance on disclosure of certain loss contingencies, which is discussed in further detail in the "On the Horizon" section of this alert.

SEC Work Plan for Consideration of IFRSs

.316 In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to the SEC's roadmap on its consideration of global accounting standards, including a confirmation of its continued support for the convergence of U.S. GAAP and IFRSs in order to narrow the differences between the two sets of standards. The SEC believes that a more comprehensive work plan is necessary to transparently lay out the work that must be done to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, time frame, and methodology for any such transition. Therefore, the SEC has indicated that it will carefully consider and deliberate whether these changes are in the best interest of U.S. investors and markets.

.317 The SEC directed its staff to execute a work plan, the results of which will aid the SEC in its evaluation of the impact that the use of IFRSs by U.S. entities would have on the U.S. securities market. The work plan includes consideration of IFRSs, both as they currently exist and after the completion of the various convergence projects underway by FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received on the roadmap, including the following:

- Sufficient development and application of IFRSs for the U.S. reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRSs
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

.318 Beginning no later than October 2010, and frequently thereafter, the SEC staff will provide public progress reports on the work plan, as well as the status of the FASB and IASB convergence projects, until the work is complete. By 2011, assuming completion of these convergence projects and the staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. Commenters provided feedback on the timing discussed in the roadmap, suggesting that a four or five year time frame would be necessary to successfully implement a change in their financial reporting systems to incorporate IFRSs. Under that assumption, if the SEC determines in 2011 to incorporate IFRSs into the U.S. financial reporting system, the first time that U.S. entities would report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of Release No. 33-9109 and also can be found on the SEC's website at www.sec.gov.

.319 In August 2010, the SEC issued two releases (Release Nos. 33-9133 and 33-9134, *Notice of Solicitation of Public Comment on Consideration of Incorporating IFRS Into the Financial Reporting System for U.S. Issuers*) to solicit public comment on its ongoing consideration of incorporating IFRSs into the financial reporting system for U.S. issuers. The first release contains requests for comment on three topics derived from the work plan that are related to the potential impact on investors. The second release contains requests for comment on three topics, also derived from the work plan, that are related to the potential impact on U.S. issuers. All comments will be available on the SEC's website.

Private Company Financial Reporting

.320 The AICPA and the Financial Accounting Foundation (FAF) established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel is also sponsored by the National Association of State Boards of Accountancy. The "blue-ribbon panel" will provide recommendations through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies

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are needed. The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities making more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries. The panel's issued report will be made available to the public, and the resulting action plan is expected to be exposed for public comment prior to that plan being finalized. The panel will issue a report containing its recommendations to the FAF board of trustees in January 2011. The report will be publicly available, and the resulting action plan is expected to be exposed for public comment prior to the plan being finalized.

.321 During the July 2010 meeting of the panel, seven alternative models for private company financial reporting were discussed. Models based on IFRSs and a model that would have resulted in no change to private company financial reporting were eliminated. All remaining models would result in differences in GAAP for private and public entities; the main focus of the panel moving forward will be to select a model that is relevant to users of private company financial reports because this has become the overriding issue. The three primary models the panel agreed to focus on going forward are U.S. GAAP with Exclusions for Private Companies; U.S. GAAP with Public Company Add-Ons; and Separate, Stand-Alone GAAP Based on Current U.S. GAAP. At the October 2010 meeting of the panel, a majority of the members decided that there is a need for a new standard-setting model that follows GAAP with exceptions for private companies. A majority also believes that a separate private company standards board should exist under the oversight of FAF. Panel members who support this separate board did note that it is important to have FASB's perspective kept as a frame of reference to the private company board and vice versa. There was also support for an extended period from two to five years whereby the members can assess the recommendations and whether any changes are necessary. A draft report containing the panel's recommendations will be discussed at the panel's meeting in December 2010.

Recent Pronouncements

.322 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.323 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801) Issue Date: December 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 801 to reflect changes in the compliance audit environment and incorporates the risk assessment standards. It requires the auditor to adapt and apply the AU sections of the AICPA's *Professional Standards* to compliance audits and provides guidance on how to do so. It is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
Interpretation No.1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, AT sec. 9501 par. .01–.07) Issue Date: September 2010 (Interpretive publication)	For insured depository institutions (IDI) that require an examination of internal controls at the IDI level, this interpretation addresses whether the auditor can meet the integrated audit requirement when an IDI does not prepare financial statements for external distribution and, if so, how the auditor can report on the effectiveness of the IDI's internal control over financial reporting.
Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 15, *Audit Evidence* (subject to approval by the Securities and Exchange Commission [SEC]) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard explains what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.
PCAOB Auditing Standard No. 14, *Evaluating Audit Results* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether the auditor has obtained sufficient appropriate audit evidence. The evaluation process set forth in this standard includes, among other things, evaluation of misstatements identified during the audit; the overall presentation of the financial statements, including disclosures; and the potential for management bias in the financial statements.
PCAOB Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements for responding to the risks of material misstatement in financial statements through the general conduct of the audit and performing audit procedures regarding significant accounts and disclosures.
PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. The risk assessment process discussed in the standard includes information-gathering procedures to identify risks and an analysis of the identified risks.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard sets forth requirements for supervision of the audit engagement, including, in particular, supervising the work of engagement team members. It applies to the engagement partner and to other engagement team members who assist the engagement partner with supervision.
PCAOB Auditing Standard No. 9, *Audit Planning* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding planning an audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan.
PCAOB Auditing Standard No. 8, *Audit Risk* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance that the financial statements are free of material misstatement.
PCAOB Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards) Issue Date: January 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard and its related amendments supersede the interim concurring partner review requirements and update the interim quality control standards. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB. The standard provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. It is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Staff Question and Answer, *Auditing Standard No. 7*, Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10) Issue Date: February 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This staff question and answer provides further implementation guidance on the documentation requirements of Auditing Standard No. 7 in light of comments the SEC received during its comment period.
PCAOB Staff Audit Practice Alert (PA) No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06) Issue Date: July 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert is intended to remind registered public accounting firms of their obligations when using the work of other firms or using assistants engaged from outside the firm. The alert was prompted by observations by the PCAOB that a number of registered public accounting firms located within the United States have been issuing reports on financial statements filed by issuers that have substantially all of their operations outside of the United States, and some of these firms may not be conducting those audits in accordance with PCAOB standards.
PCAOB Staff Audit PA No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05) Issue Date: April 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert explains that significant unusual transactions, especially those close to period-end that pose difficult substance over form questions, can provide opportunities for entities to engage in fraudulent financial reporting. This staff audit practice alert is designed to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions.

Recent ASUs

.324 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2010-25, *Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans (a consensus of the FASB Emerging Issues Task Force)*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*); ASUs that are technical corrections to various topics; or ASUs that are not applicable to the financial institutions industry. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval. For a complete list of ASUs, see www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156316498.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) ***Accounting Standards Codification*** **(ASC)**	
Accounting Standards Update (ASU) No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
Liabilities Area of FASB ASC	
ASU No. 2009-15 (October 2009)	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
Broad Transactions Area of FASB ASC	
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2009-17 (December 2009)	*Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*
ASU No. 2009-16 (December 2009)	*Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*
Industry Area of FASB ASC	
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*

Recently Issued Technical Questions and Answers

.325 The following table presents a list of nonauthoritative accounting and audit and attest technical questions and answers recently issued by the AICPA. However, this table does not include questions and answers that are not applicable to the financial institutions industry. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

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***Recently Issued Technical Questions and Answers* (AICPA, *Technical Practice Aids*)**	
Technical Questions and Answers (TIS) section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"
TIS section 9150.26 (December 2009)	"The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements"
TIS section 6910.33 (December 2009)	"Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination"
TIS section 2220.18 (December 2009)	"Applicability of Practical Expedient"
TIS section 2220.19 (December 2009)	"Unit of Account"

(continued)

Recently Issued Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
TIS section 2220.20 (December 2009)	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, *Financial Services—Investment Companies*"
TIS section 2220.21 (December 2009)	"Determining Whether an Adjustment to NAV Is Necessary"
TIS section 2220.22 (December 2009)	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"
TIS section 2220.23 (December 2009)	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
TIS section 2220.24 (December 2009)	"Disclosures—Ability to Redeem Versus Actual Redemption Request"
TIS section 2220.25 (December 2009)	"Impact of 'Near Term' on Classification Within Fair Value Hierarchy"
TIS section 2220.26 (December 2009)	"Categorization of Investments for Disclosure Purposes"
TIS section 2220.27 (December 2009)	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
TIS section 8700.01 (September 2009)	"Effect of FASB ASC 855 on Accounting Guidance in AU Section 560"
TIS section 8700.02 (September 2009)	"Auditor Responsibilities for Subsequent Events"

Recent AICPA Independence and Ethics Developments

.326 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.327 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05). Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. The PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as "maintaining internal control" for the client.

.328 To address the possible inconsistency in Interpretation No. 101-3, the PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members better distinguish between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

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.329 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

.330 Exposure drafts issued by the PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

On the Horizon

.331 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the financial institutions industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.332 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.333 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the ISAs issued by the IAASB. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117 will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the first half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU sections 341 and 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

.334 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Interim Financial Information

.335 In July 2010, the ASB issued two proposed SASs on interim financial information. The first, *Revised Applicability of Statement on Auditing Standards No. 116*, Interim Financial Information, is intended to revise paragraph 5 of SAS No. 116, *Interim Financial Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 722), so that the guidance in SAS No. 116 would be applicable when the auditor audited the entity's latest annual financial statements and the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. Currently, the guidance in SAS No. 116 is applicable when the auditor performs the audit of the latest annual financial statements and expects to be engaged to audit the current year financial statements (and, therefore, is not applicable when the auditor expects that a new auditor may be engaged for the current year). This proposed amendment would be effective for reviews of interim financial information for periods beginning after December 15, 2011, with early implementation permitted. Comments are due by October 8, 2010.

.336 The second proposal on interim financial information, *Interim Financial Information* (Redrafted), would supersede SAS No. 116 and represents the redrafting of the guidance to apply clarity drafting conventions. The main changes to existing standards are as follows:

- Replacement of the term *accountant* with *auditor*
- The change to paragraph 5 discussed in the prior paragraph
- Requirement of the auditor to issue a written report unless the review of the interim financial information is required by a third party and the third party does not require a written review report
- Allowance of oral reports for entities that are subject to external requirements to report in a manner that is substantially similar to the reporting required of issuers, pursuant to PCAOB standards
- Requirement for the auditor to perform procedures consistent with those required for acceptance of an engagement to audit financial statements
- Requirement for the review report to include a statement that the review of interim financial information was conducted in accordance with auditing standards generally accepted in the United States of America

.337 This proposed SAS would be effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2012. Comments for this proposed SAS are also due by October 8, 2010.

Exposure Drafts on Auditor's Reports

.338 The ASB issued three proposed SASs related to auditor's reports: *Forming an Opinion and Reporting on Financial Statements*, *Modifications to the Opinion in the Independent Auditor's Report*, and *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. These proposed standards are drafted with the ASB's clarity drafting conventions and are intended to converge with ISAs. The intent of issuing three separate SASs is to assist practitioners in identifying and applying the reporting requirements and guidance. The ASB has made various changes to the related ISAs to tailor them to the United States; however, these changes have not been substantial in nature.

.339 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Exposure Drafts on Special Considerations Audits

.340 Another exposure draft issued by the ASB contains two proposed SASs: *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* and *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. These proposed

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standards have been drafted with the clarity drafting conventions and are intended to converge with the equivalent ISAs. No meaningful differences exist between these proposed standards and the ISAs. *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* addresses the application of GAAS to financial statements prepared under the cash, tax, regulatory, or contractual bases of accounting. It also replaces the term *other comprehensive basis of accounting* with *special purpose framework*.

.341 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* introduces new planning, performance, and reporting requirements for these engagements. The proposed SAS also clarifies that a single financial statement and a specific element of a financial statement include the related notes.

.342 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Auditing and Attestation Pipeline—Issuers

Confirmations

.343 The PCAOB has proposed a draft auditing standard on confirmations. A concept release was originally issued in April 2009 and received 24 comment letters. This proposed auditing standard, issued in July 2010, would strengthen the requirements under the current auditing standard, AU section 330, *The Confirmation Process* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and replace it, upon final issuance of a standard and approval from the SEC. The proposed new standard

- requires confirmation procedures for specific accounts, such as receivables that arise from credit sales, loans, or other transactions, and also in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.
- incorporates procedures in response to the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating nonresponses to confirmation requests.
- updates the confirmation guidance to reflect significant advances in technology and explains that confirmation responses received electronically (for example, by fax e-mail, through an intermediary, or direct access) might involve additional risks relating to reliability. Therefore, the auditor must perform additional requirements.
- defines a confirmation response to include electronic or other media.
- enhances requirements when confirmation responses include disclaimers and restrictive language by requiring the auditor to evaluate the effect on the reliability of a confirmation response. Further, if the disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

.344 In drafting this proposed standard, the PCAOB considered the guidance contained in ISA 505, *External Confirmations*, and the AICPA's proposed guidance on confirmations. This standard is anticipated to be effective for auditors for fiscal years ending on or after December 15, 2011.

Communications With Audit Committees

.345 In March 2010, the PCAOB proposed for comment an auditing standard on *Communications with Audit Committees* and a series of related amendments to its interim standards that are intended to (*a*) enhance the relevance and effectiveness of the communications between the auditor and the audit committee and (*b*) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. Two of the new requirements would be for the auditor (*a*) to establish a mutual understanding of the terms of the audit engagement with the audit committee and to document that understanding in the engagement letter and (*b*) to evaluate the adequacy of two-way

communication between the auditor and audit committee. Additionally, the proposal also includes requirements for the auditor to communicate with the audit committee regarding the following:

- An overview of the audit strategy and timing of the audit, including a discussion of significant risks; the use of the internal audit function; and the roles, responsibilities, and location of firms participating in the audit
- Critical accounting policies, practices, and estimates
- The auditor's evaluation of the entity's ability to continue as a going concern

.346 The proposed standard would become effective, subject to SEC approval, for audits of fiscal years beginning after December 15, 2010.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.347 The year 2010 has been a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Balance sheet netting
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Statement of comprehensive income
- Discontinued operations

.348 In March 2010, the exposure draft *Conceptual Framework for Financial Reporting* was published for public comment; in late September, Statement of Financial Accounting Concepts (Concepts Statement) No. 8, *Conceptual Framework for Financial Reporting—Chapter 1,* The Objective of General Purpose Financial Reporting, *and Chapter 3,* Qualitative Characteristics of Useful Financial Information *(a replacement of FASB Concepts Statements No. 1 and No. 2)*, was issued. In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. Specifically, the boards were scheduled to expose for comment numerous major exposure drafts during the second quarter of 2010, and stakeholders voiced concern about their ability under those circumstances to provide high-quality input. The boards have developed a modified strategy to accommodate these concerns by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate consultation document seeking stakeholder input about effective dates and transition methods.

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.349 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. The boards also decided to issue separate exposure drafts to address differences in the two sets of standards on balance sheet netting of derivative contracts and other financial instruments. The IASB has also made its projects on improved disclosures about derecognized assets and other off balance sheet risks, consolidations, and insurance contracts priorities. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, have been extended into the second half of 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively affect the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the U.S. financial system.

.350 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Comprehensive Income Exposure Draft

.351 In May 2010, FASB issued a proposed ASU on comprehensive income that would require an entity to report total comprehensive income in a continuous financial statement in two parts: net income and other comprehensive income. In that financial statement, the components of net income and the components of other comprehensive income should be displayed. The proposed ASU is intended to simplify how comprehensive income is reported by eliminating two options for how items of comprehensive income are displayed. The proposed ASU contains illustrative examples of the revised financial statement. This proposed ASU is the result of a joint project as part of IFRSs and U.S. GAAP convergence, and the IASB has separately issued a similar document. The proposed amendments would be applied on a fully retrospective basis to improve comparability between reporting periods. Further, because compliance with the proposed amendments is already permitted, early adoption would be permitted. FASB plans to align the effective date with the effective date of the amendments in the proposed ASU on financial instruments. The IASB and FASB aim to finalize an improved and converged standard on other comprehensive income in the fourth quarter of 2010.

Financial Instruments Exposure Draft

.352 Also, in May 2010, FASB issued a proposed ASU, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments; removes the threshold for recognizing credit impairments, creating a single credit impairment model for both loans and debt securities; and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.
- Changes in fair value of equity securities, certain hybrid instruments, and financial instruments that can be prepaid in such a way that the holder would not recover substantially all of its investment would be recognized in net income each reporting period regardless of an entity's business strategy for those financial instruments.
- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, net income would remain conceptually unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period. With the exception of certain liabilities that qualify for the

amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period.

- The existing "probable" threshold for recognizing impairments on loans would be removed. (Currently, FASB ASC 310-10-35-4 states that the concept in U.S. GAAP is that impairment of receivables [including loans] should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. Probable is defined by FASB ASC 310-10-20 as when the future event or events are likely to occur.)
- For financial instruments with changes in fair value measured through other comprehensive income, an entity would be required to determine if a credit impairment is appropriate at the end of each reporting period based on information related to past events and existing economic conditions. An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts the entity does not expect to collect.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected (that is. based on an effective yield applied to the debt instrument less any allowance).
- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.
- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.353 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments). This proposed ASU was not issued jointly with the IASB and does not contain converged guidance; however, the goal still remains for both boards to issue comprehensive improvements to foster international comparability of financial information about financial instruments. The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009. The IASB also issued two exposure drafts on amortized cost and impairment and fair value option for financial liabilities in late 2009 and mid-2010, respectively; the third topic, hedge accounting, is still being deliberated by the IASB, and an exposure draft is expected in the near term. The boards have stated that they will consider together the comment letters and other feedback received on each board's exposure drafts in an effort to reconcile their differences in ways that foster improvement and convergence.

.354 The effective date of these amendments will be established upon issuance of the final ASU, which is expected in the second quarter of 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional 4 years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

.355 FASB has issued FAQs for the proposed ASU to clarify the proposal by answering common questions received about the proposed guidance. This document can be accessed at www.fasb.org/cs/ContentServer?c=Document_C&pagename= FASB%2FDocument_C%2FDocumentPage&cid=1176157295447. The exposure draft in its entirety and project updates can be found at www.fasb.org/cs/

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ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011123.

Revenue Recognition Exposure Draft

.356 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from Contracts with Customers*, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.357 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities (for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (*performance obligation* is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).
- determine the transaction price (*transaction price* is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.358 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*) recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

.359 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the boards plan to invite additional comment through a separate consultation on how best to transition over to the new standards. Therefore, no expected specific effective date is stated at this point. Comments on the exposure draft are due on October 22, 2010. This topic is considered by many to be the most pervasive of any FASB has ever worked on. The reader is encouraged to review the

exposure draft, consider if it is operational to you or your clients' common revenue transactions, and share any resulting concerns with FASB. The boards also anticipate holding public roundtable meetings after the end of the comment period. Updates regarding this project can be found at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011146.

Fair Value Exposure Draft

.360 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.361 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines *highest and best use* as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is considered to be irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values are not believed to depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.362 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

.363 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to IRR, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value

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of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice. However, they might affect the current practice for reporting entities that apply the in-use valuation premise more broadly.

.364 The proposed amendments regarding the application of blockage factors and other premiums and discounts in fair value measurements would make two changes to current guidance. Currently, under U.S. GAAP, use of a blockage factor in fair value measurements is only prohibited when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities) in an active market. This would be level 1 within the fair value hierarchy. The first change from the proposed amendments is that a blockage factor is not relevant and, therefore, also should not be used when fair value is measured using a valuation technique that does not use a quoted price in an active market. This would be level 2 or level 3 within the fair value hierarchy. Second, the amendments specify that fair value measurements categorized within level 2 and level 3 take into account other premiums and discounts when market participants would consider those premiums or discounts when pricing an asset or a liability, consistent with the unit of account for that asset or liability. Examples include a control premium or a noncontrolling interest discount. These proposed amendments may affect current practice for any reporting entities applying a blockage factor in fair value measurements that is measured using quoted prices and categorized within level 2 or level 3 of the fair value hierarchy.

.365 Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

- The effect on a level 3 fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances (excluding unquoted equity instruments, as provided by FASB's financial instruments exposure draft previously discussed)
- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use
- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

.366 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. A final ASU is expected to be issued in the first quarter of 2011. Updates regarding this project can be found at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156576143.

Leases Exposure Draft

.367 During the third quarter of 2010, the IASB and FASB published for public comment joint proposals to improve the financial reporting of lease contracts. These proposals would result in a consistent approach to lease accounting for both lessees and lessors—a "right of use" approach. Currently, the accounting for a lease depends on its classification; an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRSs or U.S. GAAP, whereas a capital lease results in the lessee recognizing an asset and obligation. Under the proposed guidance, lessees would not able to use the operating lease method of accounting, which would produce more complete and comparable financial reporting, in addition to reducing the opportunity to structure transactions to achieve a desired accounting outcome.

.368 Under the proposed guidance, a lessor would recognize an asset representing its right to receive lease payments, and depending on its exposure to risks or benefits associated with the underlying asset, would either (*a*) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach) or (*b*) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach). For lessees, an asset would be recognized representing the lessee's right to use the leased (underlying) asset for the lease term (the "right of use" asset), and a liability at the present value of the expected lease payments would also be recognized. The assets and liabilities recognized by both lessors and lessees would be measured on the basis that

- assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- a remeasurement is triggered when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

.369 The scope of the new leases guidance includes all leases (including leases of "right of use" assets in a sublease), other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. For leases of 12 months or less, lessors and lessees would be able to apply simplified requirements. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. New disclosures would also be required.

.370 Under this proposal, an entity will be required to adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had been applied from the beginning of the earliest period presented. Currently, no specific effective date has been stated.

.371 One of the major effects of the proposed approach to financial institutions as both lessors and lessees is expected to be the gross-up of the financial statements and the possible consequential effects to regulatory capital requirements. In addition, this proposal may have an effect on certain financial ratios and financial statement measurements.

.372 For lessees, lease expense is generally expected to accelerate compared with current operating lease treatment due to use of the interest method to amortize the lease obligation. Lessees with loan covenant ratios may also be significantly affected by this proposal.

.373 In early 2009, the boards issued a discussion paper on leases; this exposure draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors, regulators, and other interested parties since that discussion paper. The comment period is open until December 15, 2010. During the comment period, the boards will undertake further outreach activities, including public round-table meetings to ensure that the views of all interested parties are taken into consideration before the new standard is completed. Also, the boards will share and jointly consider all comment letters received. A final standard is expected in the second quarter of 2011. Project updates can be found at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011123. The AICPA has developed questions and answers to highlight the important aspects of the proposals, which can be located at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/DownloadableDocuments/EDITED_LEASES_FAQ.pdf.

Financial Statement Presentation Staff Draft

.374 FASB and the IASB are working together to establish a common standard that would improve how information is organized and presented in financial statements. This common standard is intended to address

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users' concerns that existing requirements permit too many alternative types of presentation and that information in financial statements is highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between an entity's financial statements and its financial results. In 2008, a discussion paper was issued by the boards that outlined the proposed principles for presenting financial statements in a way that portrays a cohesive financial picture of an entity.

.375 Given the magnitude of this project, the expected implementation costs, and the substantial effects it will have on financial statement presentation for many years to come, the boards decided in May 2010 to modify the strategy for this project. Before finalizing an exposure draft, the boards decided to engage in additional outreach activities that focus on the perceived benefits and costs of the proposals and the implications of the proposals for financial reporting by financial service entities. The boards plan on discussing these two areas of focus with preparers and users of financial statements. This outreach will be based on a rough draft of a proposed standard, known as a *staff draft*, and reflects the cumulative tentative decisions made by the boards, concluding with their joint meeting in April 2010. This staff draft was made publicly available solely for this purpose.

.376 The proposals in this project would be applicable to all entities, except a benefit plan within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*; 962, *Plan Accounting—Defined Contribution Pension Plans*; and 965, *Plan Accounting—Health and Welfare Benefit Plans* or IAS 26, *Accounting and Reporting by Retirement Benefit Plans*. The two core financial statement principles in this proposal are cohesiveness and disaggregation. A common structure for the statements of financial position, comprehensive income, and cash flows would be established in the form of required sections, categories or subcategory, and related subtotals. Some proposed specific changes in the classification and format of financial statements include the following:

- Related information would be displayed in the same sections, categories, and subcategory in each statement so that information is more easily associated.
- Presentation of business and financing activities would be separated as follows:
  - The business section would include items that are part of an entity's daily operations and other income generating activities.
  - The financing section would include items that are part of an entity's activities to obtain (or repay) capital.
- Discontinued operations and income taxes would be presented in their own separate sections.
- The statement of changes in equity would not include the sections and categories used in the other statements because that statement presents information solely about changes in items classified in the equity category in the statement of financial position.

.377 Further, FASB plans to propose some changes that are already required by IAS 1, *Presentation of Financial Statements*. The proposal would define and provide the requirements for a complete set of financial statements. Currently, a complete set of financial statements for the period is defined only in the FASB Concepts Statements. A *complete set of financial statements* would consist of, at a minimum, statements of financial position, comprehensive income, cash flows and changes in equity, and notes to financial statements for two periods (the current period and the previous period). Also, an opening statement of financial position would be part of a complete set of financial statements if an entity applies an accounting principle retrospectively, restates its financial statements, or reclassifies items in the financial statements.

.378 The boards' tentative decisions on financial statement presentations do differ in a few ways in relation to minimum line requirements for the statement of financial position, segment reporting, and net debt presentation. Of these three, the differing stance on segment reporting is the only significant difference. The boards now aim to issue an exposure draft in the first quarter of 2011 and a final improved and converged standard in the fourth quarter of 2011. Both the introduction to the staff draft and the staff draft can be accessed from FASB's website at www.fasb.org.

Insurance Contracts Discussion Paper

.379 In June 2010, the IASB issued an exposure draft of a proposed IFRS that would apply to all insurance contracts written by both insurance entities and noninsurance entities. Three months later, FASB issued a discussion paper to solicit broad-based input on how to improve, simplify, and converge the financial reporting requirements for insurance contracts. The solicited feedback is focused on (*a*) whether the IASB's proposal would be a sufficient improvement to U.S. GAAP to justify the cost of change; (*b*) whether the project goals of improvement, convergence, and simplification would be more effectively achieved by making targeted improvements to existing U.S. GAAP (rather than issuing comprehensive new guidance); and (*c*) certain critical accounting issues for which the preliminary views of FASB differ from the IASB's exposure draft. It is important to remember that although the project on insurance contracts is a joint project, it is not part of the boards' MoU.

.380 The discussion paper summarizes the key aspects of the IASB's exposure draft and compares the proposed changes with both the alternative preliminary views of FASB and the current guidance in FASB ASC 944, *Financial Services—Insurance*. FASB decided to issue a discussion paper rather than an exposure draft because of the following reasons:

- The extent of FASB's and the IASB's current accounting guidance for insurance contracts varies significantly; U.S. GAAP comprehensively addresses accounting for insurance contracts by insurance entities, whereas IFRSs do not have comprehensive guidance. Further, the boards have not explicitly evaluated whether the model proposed in the IASB's exposure draft would represent an improvement to U.S. GAAP.
- FASB has not determined whether one model or two models would result in more useful information about insurance contracts. FASB would like additional input from stakeholders on whether different types of insurance contracts warrant different recognition, measurement, and presentation and, if so, what criteria should be used for determining which, if any, types of insurance contracts would use each model.
- FASB is considering whether employer-provided health insurance should be included within the scope of the insurance contracts project and how recent U.S. health care reform may affect the application of the different approaches.

.381 The discussion paper also includes a listing of common elements of U.S. GAAP on insurance contracts that some stakeholders note could be improved. The appendix of the discussion paper compares the main areas of current U.S. GAAP for insurance contracts, the IASB's proposed approach, and FASB's preliminary views that differ from the proposed approach included in the IASB's exposure draft. Comments are due by mid-December 2010. Additionally, FASB and the IASB plan to host a series of public roundtable meetings in December 2010 to hear stakeholders' views. Readers should be alert for developments on this topic.

Auditing Considerations of Accounting Convergence

.382 Although the future of convergence between IASB and FASB accounting standards remains an unknown, discussions have already begun about the potential impact on auditors. Although auditors are accustomed to new standards, the nature and volume of these changes will likely pose new challenges. Among others, some of these potential challenges include the following:

- Training audit staff on a large amount of new accounting guidance that is based on a new accounting approach (that is, principles based versus rules based)
- Developing, as necessary, any new internal audit guidance, such as firm methodology
- Implementing any new resulting auditing rules
- Creating a new framework for documenting audit conclusions on a principles-based accounting approach
- Audit committees learning new accounting guidance to effectively perform their function

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.383 In addition to the challenges auditors will face, the effects on preparers will also be great. Currently, it appears that the transition timeline to convergence will be relatively short; this will divert resources during the preparation of financial statements as entities focus on implementing the new principles, which may result in increased audit risk. Auditors, in addition to preparers, are also encouraged to remain current on developments of international accounting convergence.

FASB Accounting Pipeline

Disclosure of Certain Loss Contingencies

.384 In July 2010, FASB issued an exposure draft on the disclosure of certain loss contingencies in response to concerns from investors and other financial statement users that the current disclosures do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. The objective of these disclosures would be for an entity to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following: the nature of the loss contingencies, their potential magnitude, and their potential timing (if known). Disclosure of certain remote loss contingencies would be required and, therefore, would expand the population of loss contingencies that are required to be disclosed. An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required. Further, current qualitative disclosures would be enhanced by requiring additional disclosures. These additional required qualitative and quantitative disclosures include the following:

- For litigation contingencies, the contentions of the parties and how users can obtain more information about the litigation
- Publicly available quantitative information, such as the claim amount for asserted litigation contingencies; other relevant nonprivileged information; and, in some cases, information about possible recoveries from insurance and other sources
- For public entities, tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the period

.385 The amendments in this proposal would affect all entities. The exposure draft noted that FASB will continue to work with the PCAOB, the AICPA, and the American Bar Association (ABA) to identify and address any potential implications of the proposed amendments for auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The proposed amendments would be effective for fiscal years ending after December 15, 2010, for public entities and in the first annual period beginning after December 15, 2010, for nonpublic entities. The comment period ended in September 2010.

Going Concern

.386 Currently, the only guidance on going concern resides in the auditing literature, and this project's intention is to incorporate going concern guidance into U.S. GAAP. Specifically, this guidance would discuss the following:

- Preparation of financial statements as a going concern
- An entity's responsibility to evaluate its ability to continue as a going concern
- Disclosure requirements when financial statements are not prepared on a going concern basis
- Disclosure requirements when there is a substantial doubt about an entity's ability to continue as a going concern
- The adoption and application of the liquidation basis of accounting

.387 A revised exposure draft is expected to be issued in the fourth quarter of 2010, with a final ASU expected in the first quarter of 2011. FASB has decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Readers should be alert to developments on this topic.

Balance Sheet—Offsetting

.388 A project to provide guidance on the criteria that would determine when offsetting in the balance sheet is appropriate was added to FASB's agenda in February 2010. In addition, the IASB and FASB have agreed to work together to achieve greater convergence of the criteria for balance sheet offsetting under IFRSs and U.S. GAAP.

.389 The IASB and FASB have tentatively decided that the focus of offsetting should be on financial instruments (including other items falling within the scope of the financial instruments standards) and have asked their staff to obtain additional information for future meetings. According to FASB's Current Technical Plan, FASB plans to issue an exposure draft in the fourth quarter of 2010.

Troubled Debt Restructuring

.390 In addition to the effects of the recent economic downturn, as previously noted, many lending institutions have seen an increase in the number of modifications to their loans receivable. For example, a loan might be modified to extend the term of the interest-only period or to defer or lower payments through the extension of the term over which a loan would otherwise be due. A number of constituents have raised concerns about whether additional guidance and clarity is needed to assist lenders in determining whether a modification of a loan to a borrower is a troubled debt restructuring. Currently, U.S. GAAP specifies that a modification of a loan that represents a concession to a borrower experiencing financial difficulty is a troubled debt restructuring.

.391 On July 14, 2010, FASB announced a limited scope project to FASB's agenda to achieve more consistent identification by lenders of troubled debt restructurings, thereby enhancing comparability. On August 25, 2010, FASB discussed potential clarifications to the guidance in FASB ASC 310-40 and tentatively decided the following:

- Creditors should be explicitly precluded from using the borrower's effective rate test (in FASB ASC 470, *Debt*) in their evaluation of whether a modification was executed at a market rate.
- Guidance should be clarified to note the following:
  - A situation in which a market rate is not readily available is a strong indication that the modification was executed at a rate that is below market.
  - A modification that results in a temporary or permanent increase to the contractual interest rate cannot be presumed to be at a rate that is at or above market.
- Guidance should be clarified to note that a borrower that is not currently in default may still be considered to be experiencing financial difficulty.
- A creditor should not conclude that a modification is not a troubled debt restructuring simply because a delay in payment resulting from that modification is insignificant.
- There should be no change to the guidance in FASB ASC 310-40-50-2 that allows the removal of a loan previously identified as a troubled debt restructuring from associated disclosure requirements if the criteria therein are met.
- There should be no change to the treatment of purchased credit impaired loans (that is, purchased credit impaired loans other than those accounted for within a pool under FASB 310-30 should remain in the scope of troubled debt restructuring guidance).

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.392 FASB also discussed transition and tentatively decided on effective date information for disclosure and impairment purposes. For disclosure purposes, the proposed clarifications will be effective for interim and annual periods ending after June 15, 2011, applied retrospectively to modifications occurring on or after the beginning of the earliest period presented. For impairment purposes, the proposed clarifications will be effective on a prospective basis for interim and annual periods ending after June 15, 2011. An entity should disclose the total amount of loans and the associated reserves related to those loans that are considered impaired under FASB ASC 310-10-35 as a result of the clarifications in guidance for which impairment was previously accounted for under FASB ASC 450-20.

.393 An exposure draft is expected in the fourth quarter of 2010, with a final ASU to be released in the first quarter of 2011. Readers are encouraged to access the FASB website at www.fasb.org for additional developments and final decisions regarding this topic.

Repurchase Agreements

.394 The objective of this project is to improve the accounting for repurchase transactions by amending the effective control criteria for transactions involving repurchase agreements or other agreements that both entitle and obligate the transferor to repurchase or redeem financial assets before their maturity within FASB ASC 860. The existing guidance for repurchase transactions includes a provision requiring the transferor to maintain cash or collateral sufficient to fund substantially all of the cost of purchasing replacement financial assets from others. This project will consider the importance of the cash collateral provision and whether it should be removed from the current guidance. A proposed ASU is expected in the fourth quarter of 2010, with a final ASU expected in the first quarter of 2011.

Other Accounting Projects

.395 Additionally, FASB, including the Emerging Issues Task Force, has the following projects underway:

- Disclosure framework
- Investment properties
- Debtor's accounting for real estate subject to a nonrecourse mortgage in default prior to forfeiture

Resource Central

.396 The following are various resources that practitioners engaged in the financial institutions industry may find beneficial.

Publications

.397 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* (2010) (product no. 0127310 [paperback], WDL-XX [online with the associated Audit Risk Alert], or DDL-XX [CD-ROM with the associated Audit Risk Alert])
- Audit and Accounting Guide *Brokers and Dealers in Securities* (2009) (product no. 012709 [paperback], WBR-XX [online], or DBR-XX [CD-ROM])
- Audit and Accounting Guide *Investment Companies* (2009) (product no. 0126210 [paperback], WIN-XX [online with the associated Audit Risk Alert], or DIN-XX [CD-ROM with the associated Audit Risk Alert]
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])

- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Guide *Compilation and Review Engagements* (2010) (product no. 0128110 [paperback] or WRC-XX [online])
- Audit Guide *Auditing Revenue in Certain Industries* (2010) (product no. 0125110 [paperback] or WAR-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2010/11* (product no. 0223010 [paperback])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- Checklists and Illustrative Financial Statements *Depository and Lending Institutions* (product no. 0089109 [paperback] or WDP-CL [online])
- Checklists and Illustrative Financial Statements *Corporations* (product no. 0089309 [paperback] or WCP-CL [online])
- *Accounting Trends & Techniques, 63rd Edition* (product no. 0099009 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099109 [paperback] or WIF-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Financial Reporting Alert *Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

.398 The recently issued AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* provides guidance for audits of FCMs, IBs, and commodity pools (collectively referred to as commodity entities). This practice aid is intended to provide practitioners with nonauthoritative practical guidance related to the special matters unique to the regulatory, accounting, and auditing aspects of this industry. It includes an overview of the commodity industry and a discussion of a commodity entity's functions, books, and records, including regulatory recordkeeping requirements.

.399 This second edition, prepared by the AICPA Commodity Practice Aid Task Force, has been revised to provide industry-specific guidance for commodity entities. It includes exhibits containing both sample letters and sample reports to assist auditors in reporting on the financial statements and other written assertions of commodity entities.

AICPA Online Professional Library: Accounting and Auditing Literature

.400 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification*™, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]). To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

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.401 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following:

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- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Strong Foundation* (product no. 741602 [text], 181601 [DVD/Manual], or 351601 [Additional Manual for DVD]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

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.403 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the financial institutions industry include the following:

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- *Fair Value Accounting*
- *Loan Receivables*
- *Credit Loses*
- *Equity Capital and Capital Disclosures*
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- *International Versus US Accounting*
- *Fraud and the Financial Statement Audit*
- *Public Company Update*
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.407 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.408 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conferences

.409 The AICPA offers the annual National Conference on Banks and Savings Institutions in the fall of each year. The Banks and Savings conference is a three-day conference designed to update attendees on recent developments related to audit, accounting, regulatory, legislative, and tax issues affecting the industry. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

.410 The AICPA offers the annual National Conference on Credit Unions in the fall of each year. The Credit Union conference is a three-day conference designed to update attendees on recent developments related to the credit union industry. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

.411 The National Conference on the Securities Industry is cosponsored by the AICPA and the Financial Management Society of the Securities Industry and Financial Markets Association and is geared toward practitioners in public practice and industry. This conference offers a two-day comprehensive update in industry, accounting, and regulatory matters, with key speakers from the SEC, the Federal Reserve, FINRA, the CFTC, and FASB.

The CAQ

.412 The CAQ, which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.413 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public

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discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit www.aicpa.org/InterestAreas/CenterForAuditQuality/Pages/CAQHome.aspx.

AICPA Industry Expert Panels

.414 For information about the activities of the AICPA DIEP, visit the panel's Web page at www.AICPA.org/InterestAreas/AccountingandAuditing/Community/DepositoryInstitutions/Pages/DepositoryInstitutions.aspx.

.415 For information about the activities of the AICPA Stockbrokerage and Investment Banking Industry Expert Panel, visit the panel's Web page at www.AICPA.org/InterestAreas/AccountingandAuditing/Community/InvestmentBanking/Pages/StockbrokerageInvestmentBanking.aspx.

Industry Websites

.416 The Internet covers a vast amount of information that may be valuable to auditors of financial institutions industry entities, including current industry trends and developments. Some of the more relevant sites for auditors with financial institutions industry clients include those shown in the following table:

Organization	*Website*
Commodity Futures Trading Commission	www.cftc.gov
Federal Deposit Insurance Corporation	www.fdic.gov
Federal Financial Institutions Examination Council (includes Consolidated Reports of Condition and Income Instructions)	www.ffiec.gov
Federal Reserve	www.federalreserve.gov
Financial Crimes Enforcement Network	www.fincen.gov/
Financial Industry Regulatory Authority	www.finra.org
Futures Industry Association	www.futuresindustry.org
Mortgage Bankers Association	www.mbaa.org
National Credit Union Administration	www.ncua.gov
National Futures Association	www.nfa.futures.org/
Office of the Comptroller of the Currency	www.occ.treas.gov/
Office of Thrift Supervision	www.ots.treas.gov/
Securities Industry and Financial Markets Association	www.sifma.org/

.417 The financial institutions industry practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org

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Website Name	*Content*	*Website*
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov

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[*The next page is 8161.*]

AAM Section 8060

Employee Benefit Plans Industry Developments—2011

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Employee Benefit Plans Industry Developments—2010*.

This Audit Risk Alert is intended to provide auditors of financial statements of employee benefit plans with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by plan management and plan sponsors to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Accounting and Auditing Publications

Recognition

The AICPA gratefully acknowledges the Employee Benefit Plans Guide Task Force, the Office of the Chief Accountant, and the Employee Benefits Security Administration for their essential contributions in creating this publication.

Feedback

The Audit Risk Alert *Employee Benefit Plans Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your employee benefit plan audits and also can be used by plan management and plan sponsors to address audit and accounting concerns. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and

regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) explains important issues that affect entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

.03 When planning and performing an audit of an employee benefit plan, an auditor should understand the economic conditions facing the industry in which the plan sponsor operates as well as the effects of these conditions on the employee benefit plan. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions, are likely to have an effect on an entity's business and, therefore, its financial statements. As always, continue to remain alert to changes in economic, legislative, and regulatory developments as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

The Current Economy

.04 Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. Further, after experiencing a considerable decline in the stock market through March 2009, by March 2010 all 3 national exchanges had increased in value by at least 59 percent from the previous year's lows. By December 2010 the Dow Jones Industrials, the S&P 500, and the NASDAQ Composite closed up at least 11 percent over the prior year and in January 2011 the Dow closed at over 12,000. Although substantial improvement has occurred in the markets, uncertainty continues to exist due to the varying economic indicators, the regulatory financial reform changes, and the European and Middle East economies. Accordingly there is no clear idea of what the new "normal" will be. Although the overall economy may be moving in the right direction, how long a full recovery will take, and how bumpy that recovery will be, remain to be seen.

> **Help Desk**: For a more robust discussion of the overall economic environment see the AICPA Audit Risk Alert *General Accounting and Auditing Developments—2010/11*.

.05 Individual investors have become increasingly important over the past several decades as company-funded pensions have given way to individually managed 401(k) accounts for retirement. Aon Hewitt (formerly, Hewitt Associates), a human resources consulting firm, asserts that until 2 years ago, 70 percent of the money in 401(k) accounts that it tracks was invested in stock funds. In 2010 that amount had fallen to approximately 57 percent, as investors pushed their portfolios toward bonds. Another important factor to consider is the aging of the baby-boomer generation. These investors are looking for guaranteed income during their later years and will likely move large amounts of investments away from riskier stock funds to

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more conservative bonds and bond funds. The growing demand for cash among those unable to find a job or obtain a home-equity loan may result in higher investment withdrawals. Further, as reported by Fidelity Investments, during 2010 a record number of workers made hardship withdrawals from their retirement accounts as the number of workers borrowing from their accounts reached a 10-year high.

> **Help Desk**: For more information regarding the investment economic environment see the AICPA Audit Risk Alert *Investment Companies Industry Developments—2010/11* (product number 0223610 at www.cpa2biz.com)

Employee Benefit Plan Considerations

.06 Some challenges that may affect the plan or the plan sponsor, or both, in light of the current economic conditions are as follows:

- Uncertainty over pension and health care reform.
- Defined benefit plans still facing sizable funding obligations despite partial recoveries in 2010.
- Employer commitment to retirement plans—are employers able or willing to continue to offer the current level of benefits or have they already cut such benefits due to the economy?
- Plan design changes and amendments such as lifetime income options (annuities) for 401(k) plans and Roth conversion options.
- Retirees delaying retirement causing unemployment for younger members of society as well as a labor force consisting of part-time employees with no benefits.
- The continued credit crisis, which results in significant measurement uncertainty, including accounting estimates and fair value measurements.
- Operations that are exposed to volatile markets, such as currency and real estate markets.
- Going concern and liquidity issues particularly for defined benefit plans of single and multiemployer plans due to the deficit between plan assets and the plan's accumulated plan benefit obligations and funding requirements.
- Fraudulent internal and external transactions.

.07 Although many of these challenges are not new for plan audits, consideration of the ways an employee benefit plan is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include expanding the extent of procedures applied or modifying the nature of procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect your client, auditors should consider reviewing audit procedures to ensure that risks are still adequately addressed.

Fraud Considerations

.08 When a sustained downturn in the economy occurs, the incentive or pressure to commit illegal acts increases. Greater opportunity exists due to deteriorating internal controls or lack of segregation of duties as well as increased rationalization to commit fraud. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the risk of material misstatement due to fraud.

.09 Areas of fraudulent transactions could result due to the economic crisis related to the operation of the plan. Improper valuation of alternative investments, defalcations, inappropriate vesting of participants, ineligible participants included in the plan, and inappropriate assumptions for defined benefit and health and welfare plan obligations are possible areas to consider.

.10 For a defined benefit pension plan, a significant number of layoffs at plan sponsors may add to the liquidity issues that the plan faces. For both defined benefit pension plans and defined contribution plans, a provision of the Internal Revenue Code (IRC) requires that all affected participants be fully vested in the event of a *partial termination*. This is a technical term that does not have a clear definition but has generally been interpreted to apply when 20 percent or more of the workers have lost their jobs due to an event such as a plant closing or economic downturn. Legal counsel may be needed in determining whether a partial termination has occurred. Because many defined contribution plans use forfeitures to reduce employer contributions or to pay expenses, it is important for the client to properly identify when such a partial termination has occurred. See paragraph 12.25 of the Audit and Accounting Guide *Employee Benefit Plans* for further guidance.

.11 AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), is the primary source of authoritative guidance about an auditor's responsibilities concerning the consideration of fraud in a financial statement audit. AU section 316 establishes standards and provides guidance to auditors in fulfilling their responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

The Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act

.12 In March 2010, the president signed into law a sweeping overhaul of the health care system that will affect individuals, insurance companies, health care providers, and employers. The 3 primary goals of the reform are to (1) expand coverage to those without health insurance, (2) reform the delivery system of benefits to improve quality, and (3) decrease the costs of providing health care. The various provisions of the reform will become effective over time, through 2020. The new laws contain many changes for employers to consider for financial reporting purposes. Health care reform presents challenges for employers given its many new requirements. Most of the current requirements that apply to all plans go into effect starting with plan years that begin on or after September 23, 2010. Employers who do not comply with health care reform's requirements may potentially be fined $100 per day, per employee (with limits on the penalty in the case of unintentional failures and for small employers). For further information, refer to the "Health and Welfare Plans" section in this alert.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.13 On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act, or the Act), considered to be the greatest change to financial regulation since the Great Depression, was signed into law. Although few provisions of the Act are effective immediately, Congress has designed the Act to become effective in stages with most provisions becoming effective 12 to 18 months after enactment.

.14 The Dodd-Frank Act will, among many other changes, create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisors. This legislation, although not directly affecting benefit plans, can affect certain investment advisors to benefit plans. Further information concerning the Act can be found at www.sec.gov/spotlight/dodd-frank.shtgml.

> **Help Desk—Resources for Economic Information**:The Internet covers a vast amount of information that you may find valuable. See appendix B for some of the sites not previously mentioned in this section and links to relevant documents regarding economic information

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Hot Topics

Participant Loans

.15 Financial Accounting Standards Board (FASB) Accounting Standard Update (ASU) No. 2010-25, *Reporting Loans to Participants by Defined Contribution Pension Plans*, was issued in September 2010 to amend generally accepted accounting principles (GAAP) related to how loans to participants should be classified and measured by defined contribution pension benefit plans. Previous guidance required loans to participants to be classified as plan investments, which are generally measured at fair value as required by FASB *Accounting Standards Codification* (ASC) 962-325-35-1. ASU No. 2010-25 requires that loans to participants be classified as notes receivable from participants and measured at their unpaid principal balance plus any accrued but unpaid interest.

.16 ASU No. 2010-25 amends FASB ASC 310-10, FASB ASC 962-310, and FASB ASC 962-325. ASU No. 2010-25 should be applied retrospectively to all prior periods presented, and is effective for fiscal years ending after December 15, 2010. This may require loans to participants to be reclassified in the prior periods presented. Consideration should be given to disclosing the adoption of ASU No. 2010-25 to explain this reclassification.

.17 Because loans to participants are no longer measured at fair value, FASB ASC 820, *Fair Value Measurements and Disclosures*, requirements are not applicable. Accordingly, loans to participants do not need to be presented in the fair value measurements note or in the hierarchy table as required by FASB ASC 820-10-50. Loans to participants can be removed from prior period disclosures, if applicable, because ASU No. 2010-25 is applied retrospectively.

.18 The fair value disclosures prescribed in paragraphs 10–16 of FASB ASC 825-10-50 are not required for loans to participants. In addition, ASU No. 2010-25 amends FASB ASC 310-10-50 such that certain disclosures are not required for loans to participants.

.19 The Department of Labor (DOL) still considers participant loans to be classified as an investment for purposes of the Form 5500. This results in the following considerations:

a. The DOL requires a note reconciling the financial statements to the Form 5500. Generally net assets are reconciled in total; however, if the notes reconcile subtotals within net assets then participant loans may be a reconciling item.

b. Participant loans should continue to be reported on Schedule H, line 4i—Schedule of Assets (Held at End of Year) as indicated in the instructions to Schedule H of the Form 5500. These instructions did not change as a result of ASU No. 2010-25.

c. If the trustee or custodian certifies that participant loans are complete and accurate then participant loans may continue to be subject to the limited scope exemption.

403(b) Plan Considerations

Overview of 403(b) Plans

.20 A 403(b) tax-sheltered annuity (TSA) plan is a retirement plan offered by schools, hospitals, churches, charities, and certain other tax-exempt organizations. An individual 403(b) annuity can be obtained only under an employer's TSA plan. Generally, these annuities are funded by elective deferrals made under salary reduction agreements and may include nonelective employer contributions. Participants may include the following:

- Employees of public school systems, colleges, or universities (teachers, school administrators, school personnel, professors, researchers, librarians, and so on)

- Employees of tax-exempt entities under Section 501(c)(3) of the IRC (charitable, scientific, educational, and so on)
- Employees of cooperative hospital service organizations (for example, nurses and doctors)
- Church employees and ministers
- Employees of public school systems organized by American Indian tribal governments

.21 A 403(b) plan comprises individual investment accounts that include the following types:

- Fixed and variable annuity contracts with insurance companies (403(b)(1) annuities)
- Custodial accounts made up of mutual funds (403(b)(7) accounts)
- A retirement income account set up for church employees (403(b)(9) accounts)

IRS Regulation Highlights

.22 In July 2007, the IRS issued the first comprehensive regulations for 403(b) plans, bringing 403(b) plans closer to the standards set for 401(k) plans. The new IRS regulations clarified several points on employer responsibility and required organizations to have a written plan in place. Additionally, in an effort to ease the administrative burden, the new IRS rules have the effect of encouraging employers to limit the number of investment vendors offered to employees while introducing due diligence expectations that affect the daily plan management. The new rules were effective on or after January 1, 2009, with some notable exceptions.

Filing and Audit Requirements for 403(b) Plans Covered Under the Employee Retirement Income Security Act

.23 In addition to the IRS regulations, the DOL issued amended regulations to subject Employee Retirement Income Security Act of 1974 (ERISA) covered 403(b) plans to the same Form 5500 reporting and audit requirements as 401(k) plans effective with their 2009 Form 5500 filings.

.24 A 403(b) plan generally will be covered under ERISA if there are employer contributions or if employer involvement in the plan exceeds the limitations permitted under the DOL's safe harbor regulations (see also DOL Field Assistance Bulletin [FAB] 2010-01, *Annual Reporting and ERISA Coverage for 403(b) Plans*, for specific questions and answers addressing the DOL's safe harbor regulations). *Governmental plans* (plans established or maintained by the U.S. or any state government or any political subdivision, agency, or instrumentality thereof for the benefit of its employees) and *church plans* (plans established by a church, convention, or association of churches for the benefit of its employees or their beneficiaries) are generally exempt from ERISA. In addition, other 403(b) plans that meet all of the following conditions are exempt:

- There are no employer contributions.
- The plan includes only employee voluntary contributions.
- The employer has limited involvement in the plan.
- No compensation is paid to the employer in connection with the plan.
- Rights under the plan are enforceable solely by the participants and their beneficiaries against the provider and not against the employer.

DOL FABs Related to 403(b) Plans

.25 On July 20, 2009, the DOL issued FAB No. 2009-02, *Annual Reporting Requirements for 403(b) Plans*. DOL FAB No. 2009-02 allows a plan administrator of a 403(b) plan to exclude certain contracts and accounts from plan assets for purposes of ERISA's annual reporting requirements under certain specified conditions.

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.26 Section 103(a)(3)(A) of ERISA requires the plan administrator of an employee benefit plan to engage an independent qualified public accountant (IQPA) to audit the financial statements using generally accepted auditing standards (GAAS) and to prepare an opinion regarding whether the financial statements (and any supplemental schedules required to be included in the annual report) are presented fairly in conformity with U.S. GAAP.

.27 If the plan administrator elects to exclude some or all of those contracts or accounts meeting the conditions of DOL FAB No. 2009-02 from the plan's financial statements or instructs the auditor not to perform procedures on certain or all pre-2009 contracts, or both, the auditor will need to consider the effect of the exclusions on the completeness of the financial statement presentation and restrictions on the scope of the audit. The auditor may be faced with both a U.S. GAAP departure and a scope limitation on the audit. In many cases, this could result in the auditor issuing a qualified, adverse, or disclaimer of opinion. When some or all of the pre-2009 contracts are not specifically scoped out of the audit by the plan administrator, the auditor could still have difficulty in obtaining sufficient appropriate audit evidence for prior periods to evaluate completeness, as well as the valuation of opening balances and whether assets have been properly included or excluded, which could also result in the auditor modifying his or her opinion or disclaiming an opinion. See the "Forming an Opinion and Reporting on 403(b) Plans" section of this alert for additional information regarding the auditor's report.

.28 In February 2010, the DOL issued FAB 2010-01, which supplements DOL FAB 2009-02 and addresses questions the DOL received concerning the scope of FAB 2009-02 and the safe harbor regulations at Title 29 U.S. *Code of Federal Regulations* (CFR) Part 2510.3-2(f). DOL FAB 2010-01 addresses, among other things, the plan administrator's responsibility to determine whether the conditions of DOL FAB 2009-02 have been satisfied with respect to excluded contracts from the plan's annual report.

.29 The full text of DOL FAB No. 2009-02 and DOL FAB No. 2010-01 are available at www.dol.gov/ebsa/regs/fab2009-2.html and www.dol.gov/ebsa/regs/fab2010-1.html, respectively.

Significant Differences Between 401(k) Plans and 403(b) Plans

.30 This section highlights certain areas where 403(b) plans vary from 401(k) plans. This summary is not intended to be all inclusive.

Attribute	*401(k)*	*403(b)*
Eligible employees	Employer may apply a 1 year wait, age 21 entry age, or restrict eligibility to a group that satisfies the various tax code requirements for participation, coverage and nondiscrimination.	Employees are subject to universal availability;* the 401(k) rules may apply for employer contributions. *universal availability: Once a 403(b) permits employee salary deferrals, the opportunity must be extended to nearly all employees of the organization subject to certain exceptions.
Trust Requirement	All plan assets must be held in trust or by an insurance company.	No trust requirement, trust is permitted.
Funding requirement	Any investments considered prudent by the fiduciary.	Insurance annuity contracts (traditional annuities or pooled separate accounts) or custodial accounts which invest *solely* in shares of registered investment companies.

(continued)

Attribute	*401(k)*	*403(b)*
Long service employee additional catch up contribution (beyond age 50 catch up)	None	Employees with 15 or more years of service have an additional deferral limit.
Allowable employer contributions for terminated employees in years following termination	None	Allowed for 5 years following severance.
Average Deferral Percentage Test	Applies	None
Other discrimination tests—limitation on allowable salary, Actual Contribution Percentage test, top heavy, coverage	Applies	Applies to any employer contributions. Top heavy rules do not apply.
Annual addition limits—IRC Section 415	Applies	Applies, with some unique attributes.
Distribution options	Outlined in plan document. Generally one set of salary deferrals and, possibly, another set for employer contributions.	Outlined in plan document. Distribution terms may vary by age on contract and type of investment—custodial account or annuity contract.
Required minimum distribution	Entire balance subject to these rules.	Only post-1986 balance is subject to these rules. Pre-1987 balances may be distributed over a longer period of time, if plan permits.
Prototype plan documents	Available	May be available in 2011.
IRS Determination Letter	Available	Program has not been established yet.
Nonexempt Transactions	Applies; excise tax paid under Tax Code provisions using Form 5330.	Applies; excise tax payable under Title I—DOL provision of ERISA; payment process not defined.

Engagement Letter Considerations

.31 An engagement letter represents the form of communication with the client concerning the scope of services for an audit of a 403(b) plan (see AICPA Audit and Accounting Guide *Employee Benefit Plans*, exhibit 5-5). Generally, this understanding would be obtained during the planning phase of an engagement and is part of the required communications to those charged with governance under paragraph .08 of AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), and AU section 380, *The Auditor's Communication With those Charged With Governance* (AICPA, *Professional Standards*). The standard engagement letter included in the AICPA Audit and Accounting Guide *Employee Benefit Plans* may need to be modified for an audit of a 403(b) plan, as follows:

- If the plan administrator has restricted the scope of the audit for any reason, the opening paragraph of the engagement letter may need to be revised, similar to when the limited scope audit exemption is used.[1]

[1] See footnote 7 to exhibit 5-5 in AICPA Audit and Accounting Guide *Employee Benefit Plans*, for illustrative wording when a limited scope audit is to be performed. ***Note***: The limited scope audit exemption allowed by the Department of Labor (DOL) under Title 29 U.S. *Code of Federal Regulations* (CFR) Part 2520.103-8 may not be appropriate.

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- Because many audits of 403(b) plans may be initial audits and the fact that the statement of net assets available for benefits is required to be comparative, the engagement letter needs to include appropriate language regarding the auditor's responsibility for the prior year's statement of net assets available for benefits.

Initial Audit Considerations Unique to 403(b) Plans

.32 The initial audit of a 403(b) plan will likely require significant audit effort as the auditor will need to perform procedures to test the completeness and accuracy of plan and participant-level information going back numerous years. The assets attributable to a participant's vested interest may be held in a custodial account or in an annuity contract that is issued in the participant's name, rather than the plan's name. This industry practice raises plan reporting issues and associated audit issues related to beginning balances.

.33 As part of the auditor's risk assessment procedures, determining the nature, timing, and extent of auditing procedures for an initial audit of a 403(b) plan may be more challenging than general auditing procedures for an initial audit. Many plans may face significant challenges in establishing plan accounting records and proper controls, such as identifying all participant accounts to be included as plan assets, determining beginning account balances (that is, comparative balances are required as of December 31, 2009, for calendar year plans), and obtaining other financial information to be included in the plan's financial statements. For example, plans may have multiple third-party administrator (TPA) vendors (nonexclusive administration), orphan contracts (old accounts and contracts that were not transferred to the current TPA), missing participants, or participants with multiple annuity contracts. Also, historical plan records may not be readily available or may be nonexistent for previous years.

> ***Note:*** It may be challenging to obtain a complete population of contracts and transactions for 403(b) plans because IRS Revenue Ruling 90-24 previously allowed 403(b) participants to initiate a transfer of their 403(b) assets and accounts from a vendor offered by their employer to outside-of-plan vendors without any approval of the plan sponsor.

.34 Planning the nature, timing, and extent of further audit procedures depends on the outcome of the auditors risk assessment procedures. The following is a list of factors that the auditor may want to consider when performing their risk assessment procedures for an initial audit of a 403(b) plan. This list is not intended to be all inclusive.

- Size of plan and number of years in existence
- Adequacy and organization of critical plan documents
- Incomplete or missing records (participant data, payroll, and so on)
- Disaggregation and completeness of recordkeeping information
- Identifying all current and former participant accounts to be included as plan assets
- Multiple service provider concerns
- Adequacy of internal controls
- Regulatory compliance matters
- Investment valuation and reporting
- Fraud risks

.35 The auditor should also make inquiries of the plan administrator and outside service providers, as applicable, regarding the plan's operations during those earlier years. The auditor may also obtain relevant information (for example, trust statements, recordkeeping reports, reconciliations, minutes of meetings, and

Statement on Auditing Standards [SAS] No. 70 reports[2]) for earlier years, as applicable, to determine whether any errors were noted during those years that could have a material effect on current year balances. Further, the auditor should gain an understanding of the accounting practices that were followed in prior years to determine that they have been consistently applied in the current year. Based on the results of the auditor's inquiries, review of relevant information, and evidence gathered during the current year audit, the auditor would determine the necessity of performing additional substantive procedures (including detailed testing or substantive analytics) on earlier years' balances. (See Technical Questions and Answers [TIS] section 6933.01, "Initial Audit of a Plan" [AICPA, *Technical Practice Aids*], for additional discussion of initial audits.)

.36 The inability of the auditor to obtain sufficient appropriate audit evidence supporting the accuracy and completeness of beginning balances of reported contracts and accounts is considered a restriction on the scope of the audit and may require the auditor to modify his or her opinion.

Year Two Audit Considerations Unique to 403(b) Plans

.37 In conducting an audit of a 403(b) plan in which the financial statements for the prior period included a modification to the auditor's opinion (for example, the auditor was unable to complete certain audit procedures relating to the completeness and accuracy of the beginning balances of participant accounts because the plan administrator lacked historical plan records) the auditor may consider determining whether changes have occurred during the current year that may affect the relevance of such information in the current period's financial statements. If the matter giving rise to the modification remains relevant and material to the current period's financial statements, the auditor may determine it is necessary to modify the opinion on the current period's financial statements.

.38 If the prior period's financial statements were audited by a predecessor auditor, the auditor needs to obtain sufficient appropriate audit evidence regarding whether opening balances contain misstatements that materially affect the current period's financial statements. In addition, the auditor needs to identify if appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements or, if not, changes are appropriately accounted for and adequately presented and disclosed. In this case, the auditor may be able to obtain sufficient appropriate audit evidence regarding the completeness and accuracy of opening balances by reviewing the predecessor auditor's working papers. Whether such a review provides sufficient appropriate audit evidence regarding the completeness and accuracy of beginning balances of participant accounts is a matter of judgment and is influenced by consideration of the professional competence, reputation and independence of the predecessor auditor. If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor may need to express a qualified opinion or disclaim an opinion on the financial statements. In this case, considerations may also need to be given to the use of information obtained from reviewing the predecessor auditor's working papers. See AU section 315, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*), for additional considerations regarding communications between predecessor and successor auditors.

Format for 403(b) Financial Statements and Disclosures

.39 403(b) plans are considered a type of defined contribution plan. Therefore, the financial statements and disclosures would be similar to those described in chapter 3 (and appendix E) of the AICPA Audit and Accounting Guide *Employee Benefit Plans*. However, consideration should be given concerning which disclosures may need to be modified or added. For example, the general description of the plan, eligibility requirements, funding, and tax status should reflect the requirements of the 403(b) plan document. Additional or modified disclosures of the accounting policies surrounding the accounting treatment of certain contracts may be necessary. It will be important to obtain an understanding of the operations of the plan in order to determine whether the presentation and disclosures are adequate and in accordance with U.S. GAAP. See paragraph .30 of this alert, which provides a summary of differences between 403(b) and 401(k) plans.

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[2] For information regarding updates to Statement on Auditing Standards (SAS) No. 70 reports see the "Service Organizations" section in this alert.

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Forming an Opinion and Reporting on 403(b) Plans

.40 Many plan administrators of 403(b) plans were faced with considerable challenges last year relating to the first audits of their 403(b) plans. For certain 403(b) plans, historical financial records were either maintained by the plan sponsor, provided by vendors or were able to be recreated by the plan sponsors.

.41 In many instances, however, sufficient plan records were not maintained to permit the preparation of complete financial statements or proper governance controls established over the recording and maintenance of plan data. Also, vendors used by the plan may not have been able to, or refused to, provide such data prior to 2008.

.42 The type of auditor's report ultimately depends on the auditor's professional judgment of whether the auditor believes sufficient appropriate audit evidence has been obtained to form an opinion on the financial statements. AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), distinguishes the types of reports, describes the circumstances that may require the auditor to depart from the standard report, and provides reporting guidance in such circumstances.

.43 When there is a lack of sufficient appropriate audit evidence or there are restrictions on the scope of the audit that have led the auditor to conclude that the auditor cannot express an unqualified opinion, the auditor should express a qualified opinion or disclaim an opinion. A disclaimer of opinion is appropriate when the auditor has not performed an audit sufficient in scope to enable the auditor to form an opinion on the financial statements. If the auditor disclaims an opinion, the auditor's report should give all the substantive reasons for the disclaimer.[3]

.44 According to paragraph .62 of AU section 508, when disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer, and that the scope of the audit was not sufficient to warrant the expression of an opinion. In addition, the auditor should also disclose any other reservations the auditor has regarding fair presentation in conformity with GAAP. Following are two of the reasons that a disclaimer of opinion was expressed on 403(b) plans in the initial year of the regulations (one or both may have been included in the auditor's report, as applicable).[4]

1. The plan did not maintain sufficient accounting records and supporting documents relating to certain annuity and custodial accounts issued to current and former employees prior to January 1, 2009.[5]
2. The plan excluded from investments certain annuity and custodial accounts issued to current and former employees prior to January 1, 2009, as permitted by DOL FAB No. 2009-02 and the amounts of these excluded annuity and custodial accounts and the related income and distributions are not determinable.

> ***Note*:** AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*), states that when an adverse opinion or disclaimer of opinion is issued on the basic financial statements, the auditor should not express the opinion described in paragraph .06 of AU section 551A on any accompanying information.

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[3] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles.

[4] Resources that contain actual plan financial statements and the auditor's report include ERISA Filing Acceptance System II (EFAST2) at www.dol.gov and Electronic Data Gathering Analysis & Retrieval at www.sec.gov.

[5] If the plan administrator also instructed the auditor not to perform any auditing procedures with respect to information which was certified by the trustee or custodian of the plan, as permitted by 29 CFR 2520.103-8 of the DOL's Rules and Regulations under the Employee Retirement Income Security Act of 1974 (ERISA), this may also have been included in the auditor's report.

Representation Letter Considerations for 403(b) Plans

.45 Exhibit 12-1 of the AICPA Audit and Accounting Guide *Employee Benefit Plans* includes an illustrative management representation letter for a full scope defined benefit plan audit. Because specific considerations are associated with a 403(b) plan engagement, the auditor may want to consider the following when drafting the representation letter for a 403(b) plan audit.

a. Whether the auditor issued a modified opinion on the 403(b) plan financial statements due to a departure from GAAP when the plan sponsor elected to exclude certain pre-2009 contracts as permitted by FAB 2009-02.

b. The availability of records and data relating to certain excluded contracts as permitted by FAB 2009-02 and whether the excluded contracts were considered in relation to uncorrected financial statements misstatements.

c. Whether the specific tax circumstances relating to 403(b) plans are appropriately described in the representation letter. Currently no determination letter program exists for 403(b) plans. Frequently there is no trust and the tax status is an exclusion for plan participants, rather than an exemption at the plan level.

Communicating Internal Control Related Matters Identified in an Audit

.46 AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA *Professional Standards*), establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting identified in an audit of financial statements. A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct material misstatements on a timely basis.

.47 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

.48 A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

.49 Deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses should be communicated, in writing, to management and those charged with governance as part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. See AU section 325 for complete guidance when communicating internal control matters.

Employee Benefit Plan Considerations

.50 AU section 325 requires significant consideration and judgment by the auditor to evaluate whether or not internal control over financial reporting deficiencies identified during a financial statement audit represent a significant deficiency or material weakness, and should be based upon the specific facts and circumstances related to the plan. The severity of a deficiency depends on the magnitude of the potential misstatement resulting from the deficiency or deficiencies, and whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct a misstatement of an account balance or disclosure. AU section 325 requires the auditor to consider certain internal control deficiencies, whether in design or in operation, as indicators of a material weakness.

.51 Two indicators of material weaknesses in internal control include identification by the auditor of a material misstatement of the financial statements in circumstances that indicate that the misstatement would not have been detected by the plan's controls; and ineffective oversight of the plan's financial reporting and

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internal control by those charged with governance. Therefore, when plan records have not been properly maintained, this may be a strong indicator of a material weakness in internal control over financial reporting. The auditor's assessment of whether AU section 325 communications are necessary will depend on the facts and circumstances surrounding each plan and its internal control.

Help Desk: Paragraph .15 of AU section 325 identifies indicators of material weaknesses in internal control. Exhibit B of AU section 325 provides examples of circumstances that may be deficiencies, significant deficiencies, or material weaknesses.

The AICPA Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) is intended to assist in understanding the requirements of SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, AU sec. 325), and provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; you can obtain this alert by calling the AICPA at (888) 777–7077 or visiting www.cpa2biz.com. See also the AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) *SAS No. 115 Toolkit* for additional information concerning the implementation of SAS No. 115.

Fair Value Measurements and Disclosures

.52 FASB ASC 820 defines fair value, sets a framework for measuring fair value, and requires certain disclosures about fair value measurements. For plan assets and liabilities that are traded in active markets, fair value is determined based on quoted market prices. If quoted market prices for identical assets and liabilities are not available, the plan uses valuation techniques that should maximize the use of observable inputs (assumptions based on market data) and minimize the use of unobservable inputs. In measuring fair value, the plan should make adjustments for risks and uncertainties if a market participant would include such an adjustment in its pricing. FASB ASC 820 requires entities to make certain disclosures for each major class of assets and liabilities that are measured at fair value, including the level within the fair value hierarchy in which the fair value measurements fall as discussed in FASB ASC 820-10-35. For disclosure requirements, refer to FASB ASC 820-10-50.

.53 "Pending Content" in FASB ASC 820-10-50-2A states that for equity and debt securities, class should be determined on the basis of the nature and risks of the investments in a manner consistent with the guidance in FASB ASC 320, *Investments—Debt and Equity Securities* (FASB ASC 320-10-50-1B), even if the equity securities or debt securities are not within the scope of FASB ASC 320.

.54 According to FASB ASC 320-10-50-1B, major security types should be based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, all of the following should be considered: the activity or business sector, vintage, geographic concentration, credit quality, and economic characteristic.

.55 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers among the three levels and the underlying reasons for such transfers would be useful to financial statement users.

.56 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.57 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.58 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

.59 This guidance is located in FASB ASC 820-10-50 and 820-10-55 and is labelled as "Pending Content" due to the transition and open effective date information contained in FASB ASC 820-10-65-7.

.60 Readers are encouraged to consult the aforementioned "Pending Content" for illustrative disclosure examples that may provide useful information regarding the level of disaggregation for current year financial statement disclosures.

Fair Value Determination When the Volume or Level of Activity Has Significantly Decreased

.61 Paragraphs 51A–51H of FASB ASC 820-10-35 clarifies the application of FASB ASC 820 in determining fair value when the volume and level of activity for the assets or liability has significantly decreased. Guidance is also included in identifying transactions that are not orderly. In addition, select paragraphs in 59A–59I of FASB ASC 820-10-55 provide illustrations on the application of this guidance.

Fair Value Measurements of Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

.62 Paragraphs 59–62 of FASB ASC 820-10-35 provide additional guidance on the fair value measurements of investments in certain entities that calculate net asset value (NAV) per share (or its equivalent). This guidance permits, as a practical expedient, a reporting entity to estimate the fair value of an investment, that is within the scope of the guidance, using the NAV per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies*, as of the reporting entity's measurement date.[6]

.63 "Pending Content" in FASB ASC 820-10-50-6A requires disclosures for each class of investment about the attributes of investments within the scope of paragraphs 4–5 of FASB ASC 820-10-15, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. These disclosures are required for all investments within the scope of paragraphs 4–5 of FASB ASC 820-10-15 regardless of whether the practical expedient in FASB ASC 820-10-35-59 has been applied.

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[6] The AICPA issued a series of Technical Questions and Answers (TIS) to provide nonauthoritative guidance to assist reporting entities with the provisions of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures* (specifically, Accounting Standards Update No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculated Net Asset Value per Share (or Its Equivalent)*) to estimate the fair value of investments in certain entities that calculate net asset value. TIS sections 2220.18–.27 (AICPA, *Technical Practice Aids*) apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15.

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Help Desk: The AICPA has published TIS sections for auditors and financial statement preparers to help them gain a clearer understanding of the accounting rules for determining the fair value of investments in certain entities that calculate NAV. These entities, often called alternative investments, include hedge, private equity, and real estate funds. TIS sections 2220.18–.27 (AICPA, *Technical Practice Aids*) offer nonauthoritative implementation guidance to ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculated Net Asset Value per Share (or Its Equivalent)*.

These TIS sections cover a series of issues related to ASU No. 2009-12, including

- determining whether NAV calculation is consistent with FASB ASC 946.
- determining whether an adjustment to NAV is necessary.
- certain disclosure considerations.

You can find these TIS sections at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Effect on Employee Benefit Plans and Plan Sponsors

.64 Meeting the requirements of FASB ASC 820 requires coordination among plan management, custodians, investment fiduciaries, and auditors. U.S. GAAP requires plan management to take responsibility for the valuation of investments. Form 5500 requires assets to be reported at current value. Plan management has a fiduciary responsibility to ensure the accuracy of the information reported on the Form 5500. The nonauthoritative practice aid *Alternative Investments—Audit Considerations* states that management of the investor entity is responsible for the valuation of alternative investment amounts as presented in the investor entity's financial statements and this responsibility cannot, under any circumstances, be outsourced or assigned to a party outside of the investor entity's management. Therefore, plan management can delegate but not abdicate its valuation responsibility. Although plan management is responsible for establishing an accounting and financial reporting process for determining fair value measurements, plan management will typically rely on the trustee or custodian for the pricing of its investments. The trustee or custodian may use an outside service provider or pricing service for valuation of the investments. Because many plans outsource investment management activities to third-party service providers, information regarding the pricing and valuation of the plan's investments may not be fully transparent to those responsible for financial reporting.

.65 Plan management is ultimately responsible for the fair values reported in the financial statements and is obligated to carefully consider how third-party input is used in estimating fair value. Accordingly, plan management needs to understand and document the pricing inputs used by plan custodians and others used to value each plan investment in order to properly classify each investment into the appropriate level within the FASB ASC 820 hierarchy. Plan management will need to obtain pricing service documentation describing the valuation methods they or their custodians use to support their fair value hierarchy. Pricing services, typically used by plan trustees or custodians to provide investment prices, usually prepare this information.

.66 Accordingly, for full scope audits, auditors need to consider the procedures and controls put in place by plan management and service providers to identify hard to value investments and validate the reliability of fair value procedures. Auditors may also consider the need to enhance audit procedures to ascertain that prices obtained from pricing services are reasonable, including the use of multiple pricing sources or valuation experts to review any pricing models or fair value methodologies put in place, or both. It has been noted in practice that the level of disclosures included in plan financial statements for the implementation of FASB ASC 820 and subsequent amendments vary by benefit plan. Certain plan sponsors have included more detailed disclosures than others to meet the requirements. A greater understanding of the requirements by plan sponsors could contribute to more robust financial statement disclosures. For example, according to FASB ASC 320-10-50-1B, major security types are based on the nature and risks of the security. In determining whether disclosure for a particular security type is necessary and whether it is necessary to further separate a particular security type into greater detail, all of the following should be considered: the activity or business sector, vintage, geographic concentration, credit quality, and economic characteristic. Plan management should be

considering the nature and risks of investments in determining major security types for FASB ASC 820 disclosures.

Help Desk: The following guidance would be applicable for audits of issuers, such as Form 11-K audits (annual reports of employee stock purchase, savings, and similar plans pursuant to Section 15[d]):

a. PCAOB Staff Audit Practice Alert No. 2, *Matters Related to Auditing Fair Value Measurements of Financial Instruments and the Use of Specialists* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.02)

b. PCAOB Staff Audit Practice Alert No. 4, *Auditor Considerations Regarding Fair Value Measurements, Disclosures, and Other-Than-Temporary Impairments* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.04), and

c. *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*.

You can find the PCAOB report at http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf.

Fair Value Considerations in Limited Scope Audits

.67 For limited scope audits, if the auditor becomes aware that the certified information relating to investments is inaccurate as a result of valuation or other concerns, further inquiry may be necessary that might result in additional testing or modification to the auditor's report. See the "Limited-Scope Audits Under DOL Regulations" section of this alert for further guidance.

.68 The auditor's responsibilities for investments covered by the limited scope audit exemption permitted by 29 CFR 2520.103-8 are discussed in paragraphs 7.73–.77 in the AICPA Audit and Accounting Guide *Employee Benefit Plans*.

.69 Plan management's decision to rely on a certification for purposes of limiting the scope of the audit as permitted by 29 CFR 2520.103-8 has become increasingly more challenging, especially in light of recent economic events as well as the guidance in FASB ASC 820. Because plans increasingly invest in alternative investments, including hedge funds, real estate, limited partnerships, private equity funds, and other hard-to-value investments, care should be taken by plan management when determining if certified information can be relied upon in preparing the plan's Form 5500 and related financial statements.

.70 Plan management will need to have sufficient understanding of the nature of the plan's investments and the valuation methodologies, key assumptions, and inputs used to determine fair value. Plan management cannot outsource or assign its responsibility for properly reporting fair value of the plan's investments, even in situations when the plan's trustee or custodian certifies the completeness and accuracy of the plan's investments for a limited scope audit. Therefore, prior to being engaged to perform a limited scope audit as permitted by 29 CFR 2520.103-8, it is recommended that plan management and the auditor discuss the nature of the investments held by the plan, including how those investments are valued and where they fall in the fair value hierarchy, to help ensure that plan management engages their auditor to perform the appropriate type of audit.

Help Desk: FASB ASC 820 does not change the auditor's responsibility in a limited scope audit permitted by 29 CFR 2520.103-8. Third parties may provide pricing methodology information that assists plan management in determining the fair value hierarchy levels, or may provide preliminary suggestions of the fair value hierarchy levels. It is ultimately the responsibility of the plan's management to understand the basis for the designations to determine whether the plan's investments have been valued and disclosed in accordance with U.S. GAAP or whether revisions are necessary.

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.71 If the auditor becomes aware that the certified information relating to such investments is inaccurate as a result of valuation or other concerns, further inquiry may be necessary that may result in additional testing or modification to the auditor's report. For example, when a plan has significant interests in alternative investments that are hard to value or fall within level 3 of the fair value hierarchy, this may prompt the auditor to inquire whether these investments are covered by the certification, the method used to value these investments, and whether they are reflected in the certification at fair value in accordance with U.S. GAAP. Upon further inquiry, if the auditor becomes aware that adequate year-end valuation procedures have not been performed and therefore the financial statements may not be prepared in conformity with U.S. GAAP, the auditor would communicate those findings to the plan management. It is the plan management's responsibility to prepare the financial statements and note disclosures in conformity with U.S. GAAP and in compliance with DOL rules and regulations. Accordingly, plan management may request the trustee or custodian to recertify or amend the certification for such investments at their appropriate year-end values or to exclude such investments from the certification. If the trustee or custodian amends the certification to exclude such investments from the certification, or if the trustee or custodian does not recertify those investments, plan management is responsible for valuing such investments as of the plan year-end and engaging the auditor to perform full scope audit procedures on the investments excluded from the certification. Paragraph 7.77 of the AICPA Audit and Accounting Guide *Employee Benefit Plans* contains an illustrative auditor's report when plan investments have been certified and plan management was unable to determine whether the investment information is valued in conformity with U.S. GAAP.

.72 If the trustee or custodian only certifies a portion of the investments or excludes certain investments from the certification, this ordinarily would not affect the limited scope (DOL disclaimer as permitted by 29 CFR 2520.103-8) language in the auditor's report. Accordingly, the note pertaining to certified information should reflect only the investment information that was included or derived from the certified information.

Auditing Fair Value Measurements

.73 As previously stated, it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with U.S. GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*).

.74 The strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 of AU section 328 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information.

.75 According to FASB ASC 820, this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.

- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)

.76 It is also important for the auditor to evaluate the reasonableness of the determination within the fair value hierarchy of inputs. FASB ASC 820 defines level 1 inputs as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date; level 2 inputs are defined as inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly; and level 3 inputs are defined as unobservable inputs for the asset or liability. Further, in some cases the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety. This classification by management has long-reaching effects in the financial statements through the various classification-based required disclosures. Auditors should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. As stated in paragraph .07 of AU section 312, misstatements can result from error or fraud and may consist of a financial statement disclosure that is not presented in conformity with GAAP.

.77 In certain instances, the auditor may need special skills or knowledge to plan and perform auditing procedures for privately held employee stock ownership plans (ESOPs) or plans that hold alternative investments and subprime mortgage-backed securities. AU section 332 states that for some derivatives and securities, U.S. GAAP may prescribe presentation and disclosure requirements. Furthermore, AU section 332 advises the auditor to consider the form, arrangement, and content of the financial statements (including the notes) when evaluating the adequacy of presentation and disclosure. Auditors may also consider using a specialist when determining how to audit a plan that includes hard to value investments. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance on the use of a specialist during an engagement. Also refer to the "Using the Work of a Specialist" subsection of this alert.

Valuation Testing

.78 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective.

.79 When an entity performs its own valuation, procedures to test fair value include the following:

- Assessing the reasonableness of key factors and assumptions
- Comparing the assumptions to industry reports or benchmarks

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- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

.80 When extensive judgment is needed, consider using a specialist and refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.81 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles.

Help Desk: Refer to the following websites for helpful information on investment pricing services and valuation:

- www.bloomberg.com/
- www.idc.com/
- www.reuters.com/
- www.standardandpoors.com/home/en/us

Auditing Accounting Estimates

.82 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include fair value estimates, the actuarial present value of accumulated plan benefits for defined benefit plans or benefit obligations for health and welfare plans.

.83 Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

.84 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet performance expectations, the determination of the reasonableness of management's accounting estimates would be made with an extra degree of professional skepticism. As noted by AU section 316, when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.85 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342.

Using the Work of a Specialist

.86 It may be necessary to use a specialist (such as a securities valuation expert or actuary) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336 provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311 is applicable rather than AU section 336.

.87 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are the responsibility of the specialist, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements.

Stable Value Funds

.88 Many employer-sponsored defined contribution plans offer an investment alternative often referred to as a stable value fund. Plans can invest directly in stable value contracts or through a stable value fund vehicle such as a collective investment trust. FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*, allows stable value contracts to be presented at contract value for purposes of determining the net assets available for benefits for a defined contribution plan if the contract meets the definition of benefit responsiveness in accordance with FASB ASC 960-325.

.89 As a result of recent credit market events, some of the issuers of these contracts may have experienced a decline in credit worthiness. In addition, as a result of depreciation in the mortgage-backed securities and related markets, an increase in the difference between fair value and contract value for synthetic guaranteed investment contracts has resulted in greater risks relating to these contracts. For example, certain issuers are requesting to terminate or renegotiate contracts, limiting future contributions or redemptions, or increasing wrap fees.

> **Help Desk**: As a result of recent economic events, a decrease in the number of wrap providers has occurred. Consequently, many plan sponsors have entered into new contracts with existing wrap providers which may have different terms.

.90 In addition, certain issuers are deciding to no longer offer stable value products or are exiting the business altogether, thereby limiting the number of stable value alternatives for plan sponsors. Any new or renegotiated contracts must meet the benefit responsive requirements of FASB ASC 960-325 in order to be recorded at contract value on the plan's financial statements. Reading stable value contracts would enable auditors to gain an understanding of the terms for (*a*) events that limit the ability of the plan to transact at contract value with the issuer (for example, premature termination of the contracts by the fund, plant closings, layoffs, plan termination, bankruptcy, mergers, and early retirement incentives), and (*b*) events and circumstances that would allow issuers to terminate fully benefit-responsive investment contracts with the fund and settle at an amount different from contract value (for example, breaches of investment guidelines, investments in default, and so on).

.91 For appropriate financial statement accounting and reporting, it is important for the auditor to give careful consideration to the ability of the issuer to comply with the terms of the contract, the benefit-responsive provisions, the credit worthiness of the wrap provider and other risks relating to investing in these products.

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As a result of these industry issues, the plan sponsor may experience difficulties in obtaining certain inputs to determine a fair value for these products (for example, inability to obtain rebid quotes).

.92 Often the plan sponsor will look to an outside service provider to assist in the mechanics of the valuation. However, in practice, the outside service provider may not be able to assist in the mechanics of the valuation and the plan sponsor may have difficulties in determining fair value for the stable value investment. In these circumstances, the plan sponsor may consider the feasibility of alternative valuation methodologies or consultation with a valuation specialist, or both.

Observations Related to Audit Risk Areas Affected by the Economic Crisis

.93 In September 2010, the PCAOB released *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*. This report was issued to discuss the audit risks and challenges that resulted from the economic crisis that the PCAOB identified through its inspection program. This report covers inspections from the 2007, 2008, and 2009 inspection cycles, which generally involved reviews of audits of issuers' fiscal years ending from 2006–2008. One of the heightened risk factors identified by the PCAOB that is of particular importance to employee benefit plans is in the audit area of fair value measurements. The economic crisis increased uncertainty around fair value measurements, which significantly increased audit risk. Failing to properly test issuers' fair value measurements and disclosures may lead to the auditor not detecting a material misstatement in issuers' financial statements, which may cause investors to be misled.

.94 Although the PCAOB report focused on observations relating to issuers (for example, Form 11-Ks[7]), the key message in the report relating to testing fair value measurements are based on GAAS and could apply for all full scope employee benefit plan audits.

.95 The following is a summary of the PCAOB observations that plans may find pertinent. As part of the audit, firms sometimes planned to test issuers' estimates of fair value of financial instruments by performing procedures that included evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data. Deficiencies observed by inspectors included firms' failures to

- evaluate, or evaluate sufficiently, whether fair value measurements were determined using appropriate valuation methods. In some cases when the issuer used an external valuation, the firms failed to obtain a sufficient understanding of the valuation methods used by these third parties.
- test, or adequately test, controls over issuers' valuation processes. In some cases, by failing to test, or test sufficiently, the operating effectiveness of internal controls over various aspects of issuers' valuation processes, the firms did not have adequate support for the degree of reliance placed on these controls.
- evaluate or evaluate sufficiently, the reasonableness of management's significant assumptions. Examples of this include not performing tests beyond inquiries of management; not appropriately evaluating the reasonableness of assumptions such as discount rates, credit loss expectations, and prepayment assumptions; and not involving a valuation specialist when appropriate.
- evaluate available evidence that was inconsistent with issuers' fair value estimates.

.96 Alternatively, some firms evaluated issuers' estimates of fair value of financial instruments by developing an independent expectation of fair value. Firms often used external pricing services or external valuation specialists to make this evaluation. Deficiencies of the firms observed in this situation included failing to understand the methods or assumptions used by these external parties and failing to evaluate significant differences between the independent estimates used or developed by firms and the fair values recorded by issuers.

.97 Further, firms sometimes failed to test, or test sufficiently, significant, difficult-to-value securities (for example, limiting their testing to inquiries of issuer personnel). Firms also failed to perform sufficient

[7] As noted in paragraph 1.04 of Audit and Accounting Guide *Employee Benefit Plans*, plans that are required to file Form 11-K would be considered issuers.

procedures in light of the volatile market conditions, to provide a reasonable basis for extending to year end the conclusions regarding the valuation of investment securities that were reached at an interim date. There were also instances in which firms failed to perform sufficient tests to determine whether issuers' fair value disclosures were in conformity with the requirements of FASB ASC 820.

.98 The report also discusses deficiencies observed in other audit areas affected by the economic crisis. The observations from this report will serve to inform future PCAOB actions in connection with certain inspection, enforcement, and standard-setting activities, and consideration will be given regarding whether additional guidance is needed relating to existing standards. You can access the report at www.pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf

Lessons Learned from 1st EFAST Filings

.99 ERISA Filing Acceptance System II (EFAST2) is the all-electronic system designed by the DOL, IRS, and Pension Benefit Guaranty Corporation (PBGC) for the submission, receipt, processing, and accessing of the Form 5500 and Form 5500-SF. These forms must be electronically filed each year by employee benefit plans to satisfy annual reporting requirements under ERISA and the IRC.

.100 Under EFAST2, filers choose between using EFAST2-approved vendor software or the government's IFILE website to prepare and submit the Form 5500 or Form 5500-SF. EFAST2-approved software generally provides more value-added features than the government web application. Completed forms are submitted electronically via the Internet to EFAST2 for processing.

.101 The EFAST2 website, www.efast.dol.gov, provides filers with a variety of tools and guidance, including the 2010 Form 5500 and Form 5500-SF schedules and instructions, FAQs, user guide, and a tutorial. Filers and preparers can register for an account, complete the required forms and schedules online in multiple sessions, print a copy for their records, and submit it at no cost.

Common Problem Areas

.102 In its inaugural filing year, the EFAST2 system has received approximately one million 2009 Form 5500 and 5500-SF filings. The most common problem areas identified are as follows:

- Missing or invalid signature of the plan administrator or plan sponsor;
- Failure to attach an accountant's opinion;
- Inclusion of an attachment that was not able to be processed;
- Failure of a final plan filing to satisfy the termination criteria; and
- Indication that a plan's filing was beyond the due date.

Filing Tips

.103 For the 2011 filing season (of the 2010 Form 5500 and Form 5500-SF), plan administrators should

- register for credentials with EFAST2 in order to electronically sign the Form 5500 even if using third party software (unless they are using the e-signature option);
- know that if they cannot remember the answer to the EFAST2 website security question, they will not be able to log into their EFAST2 website account. As a result, they could lose access to filings being created or information regarding filings previously submitted;
- remember that any filings registered to a revoked account, that have not been submitted for processing, cannot be retrieved;
- ensure that if they are not attaching an accountant's opinion with their Form 5500, they do not fill out Schedule H, Part III, Lines 3a, 3b or 3d. Doing so will result in a filing status of "Filing Error";

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- ensure that their Accountant's Report is in PDF format and not encrypted or password protected. EFAST2 cannot process these attachments if they are encrypted or password protected; and
- remember that the 2010 Form 5500 and 5500-SF cannot be filed on a 2009 form, even if their software provider has not released their 2010 version of the software. Check the EFAST2 website to verify that the software has been certified for 2010.

Filing Amended Returns

.104 Delinquent and amended Form 5500 and Form 5500-SF filings must be submitted electronically through EFAST2. To submit a delinquent or amended Form 5500 or Form 5500-SF for prior plan years, filers must submit the filing using current filing year Form 5500 schedules and instructions except as provided subsequently. The electronic filing of the delinquent or amended Form 5500 or Form 5500-SF must indicate, in the appropriate space at the beginning of the electronic Form 5500, the plan year for which the annual return/report is being filed.

.105 Filers using EFAST2 must use the following correct-year schedules (that is, the plan year for which the annual return/report relates) completed in accordance with the related correct-year instructions:

- Schedule B, SB, or MB (Actuarial Information);
- Schedule E (ESOP Annual Information);
- Schedule P (Annual Return of Fiduciary of Employee Benefit Trust);
- Schedule R (Retirement Plan Information); and
- Schedule T (Qualified Pension Plan Coverage Information).

Help Desk: To obtain correct-year schedules and related instructions, filers should go to the EFAST2 website, www.efast.dol.gov, and print the schedules and instructions of the form year that corresponds to the plan year for which the filing relates.

It is important to note that filers do not attach any Schedule SSA to any filing with EFAST2. Rather, this information should be submitted on the most current year Form 8955-SSA[8] to the IRS (along with all required attachments). Additional information is available at www.irs.gov/ep.

Other Accounting Issues and Developments

Disclosures About Derivative Instruments and Hedging Activities

.106 Guidance was effective for the first time last year which expanded the disclosure requirements in FASB ASC 815, *Derivatives and Hedging*, about an entity's derivative instruments and hedging activities. FASB Statement No. 161, *Disclosures About Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, which was codified in FASB ASC 815, is effective for financial statements issued for fiscal years beginning after November 15, 2008. The disclosure provisions of this statement apply to employee benefit plan financial statements. The guidance required more robust qualitative disclosures and expanded quantitative disclosures. A summary of the main requirements follows.

.107 For employee benefit plan financial statements, it is not necessary to designate certain derivatives as hedging instruments under FASB ASC 815. FASB ASC 815 requires entities to distinguish between instruments used for risk management (defined as derivatives designated as hedging instruments under FASB ASC 815 and those that serve as economic hedges) and instruments used for other purposes, and to make disclosures separately for the two types of instruments. Because employee benefit plan financial statements account for derivative instruments at fair value and record all associated fair value changes in the statement of changes in net assets available for benefits (and not to comprehensive income), such distinction is not applicable to employee benefit plan financial statements and is not described in this summary.

[8] See paragraph .280 in this alert for additional information on Form 8955-SSA.

Effect on Employee Benefit Plans and Plan Sponsors

.108 Derivative financial instruments are commonly used in employee benefit plan investment portfolios, especially in defined benefit pension plans. In the past, some plans may not have had disclosures for derivative instruments because the year-end net fair value was not considered material. However, disclosure of the gross amounts of derivative instruments is now required. Consequently, consideration of materiality may focus instead on the gross notional value, volume of derivatives used during the year, gain or loss from derivatives during the year and overall risk relative to the entire investment portfolio instead of the net fair value. As a result, it is expected that these new disclosure requirements are applicable to employee benefit plan financial statements for those plans that use derivative financial instruments.

.109 Some challenges during the first year of implementation included gathering the detailed information and gaining an understanding of the derivatives that were used and how they were reported. Although the plan sponsor is responsible for establishing an accounting and financial reporting process, plan sponsors typically rely on the trustee or custodian and investment manager for the information needed for the disclosures. Much of the information was with the investment managers and required coordination among plan management, custodians, investment managers, and auditors.

Summary of the Amended Disclosures

Qualitative Disclosures

.110 An entity with derivatives should describe the following:

- How and why it uses derivative instruments
- How derivative instruments and related hedged items are accounted for under FASB ASC 815
- How derivative instruments and related hedged items affect the entity's financial position, financial performance, and cash flows

.111 The existing requirements of FASB ASC 815 to disclose an entity's objectives for holding or issuing derivative instruments, the context needed to understand those objectives and its strategies for achieving those objectives, have been retained. However, it also requires that such information be disaggregated by the primary underlying risk exposure (for example, interest rate, credit, foreign exchange rate, or overall price).

.112 Entities are also required to describe the volume of their derivative activity; however, no specific format is prescribed and entities must tailor such disclosure to their specific situations.

Quantitative Disclosures

.113 The quantitative disclosure requirements added by FASB Statement No. 161 are fairly detailed and illustrative disclosures are included in the text of the statement.

Tabular Disclosures

.114 One of the more significant disclosure requirements is for entities to provide tabular disclosures of the location, by line item, of fair value amounts in the statement of financial position (net assets available for benefits) and the location, by line item, of amounts of gains and losses reported in the statement of financial performance (statement of changes in net assets available for benefits).

.115 FASB Statement No. 161 also amends FASB ASC 825, *Financial Instruments*, to clarify that derivative instruments are subject to the concentration of credit risk disclosures required by FASB ASC 825. Although FASB intended the provisions in FASB ASC 825 to apply to all financial instruments, including derivatives, it believes the clarification was necessary to address diversity that has developed regarding whether entities' disclosures about concentration of credit risk should include derivative instruments.

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Securities and Exchange Commission Letter Regarding Disclosure of Derivatives

.116 In a July 30, 2010, letter to the Investment Companies Institute, the Securities and Exchange Commission (SEC) staff made a number of comments regarding derivative related disclosures by investment companies in prospectuses and shareholder reports (http://sec.gov/divisions/investment/guidance/ici073010.pdf). Such comments may be informative to employee benefit plan financial statement preparers and their auditors given the similarity between fund and employee benefit plan accounting and reporting of derivative activities. Comments included how and why derivatives were used during the reporting period rather than how they "may" be used, volume disclosures, and identification between purchased and written derivatives.

Help Desk: The following are additional resources for derivatives accounting and reporting:

- FASB ASC 815 (example disclosures)
- AICPA Audit and Accounting Guide *Investment Companies*
- AICPA Audit Guide *Auditing Derivative Instruments, Hedging Activities and Investments in Securities*
- AICPA Audit Risk Alert *Investment Companies Industry Developments—2010/11*

Securities Lending

.117 Many large pension plans and master trusts (for example, those with $1 billion or more in investments) and some smaller pension plans or master trusts, participate in securities lending. Securities lending generally requires certain reporting on the face of the statement of net assets and in the notes. Securities lending activity is often not apparent from the trustee or custodian investment statements and consequently the reporting is missed. Often, plan sponsors are unaware of securities lending activities in their plans. A best practice is to inquire of the client as to the existence of securities lending by the plan or master trust, and include a representation in the management representation letter. For example, the representation could state that securities lending, including securities on loan, collateral held under securities lending agreements, and the liability to return collateral held under securities lending agreements has been appropriately identified, properly recorded, and properly disclosed in the financial statements. In addition, the existence of securities lending may be added as an item in the investment confirmation or, in limited scope audits, where a confirmation is not obtained, inquiring directly of the trustee or custodian as to the existence of securities lending.

.118 As a result of the recent market issues with securities lending programs, many employee benefit plans revised existing securities lending agreements. Identification of such revisions can be achieved through discussion with those responsible at the plan sponsor for investment decisions; discussion with the investment service providers or through the review of all related agreements; or both.

.119 It is important to consider such revisions in securities lending agreements in determining the proper accounting, auditing, and reporting in accordance with FASB ASC 860, *Transfers and Servicing*.

.120 For guidance on the accounting and reporting for transfers of financial assets, including securities lending, consult FASB ASC 860. Also refer to paragraphs 2.28–.32, 3.36–.40, and 4.53–.57 of AICPA Audit and Accounting Guide *Employee Benefit Plans* for further information.

Insurance Company Products Offered to Employee Benefit Plans

.121 Insurance companies offer a number of different investment alternatives for employee benefit plans. An employee benefit plan's investment arrangement with an insurance company is typically established pursuant to a contract. That contract could be either an insurance contract or an investment contract. An insurance contract subjects the insurer to significant insurance risks such as the mortality or morbidity of the contract holder. An investment contract does not subject the insurer to such risks and, therefore, is comparable to financial or investment products offered by other types of financial institutions. A plan may invest assets in an insurance company's general account or a separate account at the insurance company.

.122 Understanding the contract provisions is critical in determining the appropriate financial statement and Form 5500 accounting and reporting for these contracts, as well as the design of appropriate audit procedures. See the "Stable Value Funds" section following paragraph .88 of this alert for more information regarding these contracts.

Allocated and Unallocated Funding Arrangements

.123 In determining the proper accounting and reporting, paragraph 7.37 of AICPA Audit and Accounting Guide *Employee Benefit Plans* indicates that the fundamental basis of distinction in classifying contracts for accounting purposes is (*a*) whether the contributions are currently used to purchase insurance or annuities for the individual participants, or (*b*) whether some or all of the contributions are accumulated in an unallocated fund to be used to meet benefit payments as they come due or to purchase annuities for participants at retirement or on earlier termination of service with a vested right. Contractual arrangements under which funds are currently allocated to purchase insurance or annuities for individual participants are referred to as *allocated* funding arrangements, whereas other arrangements are called *unallocated* funding arrangements.

.124 Allocated funding arrangements include annuity contracts. An *allocated contract* is a contract with an insurance entity under which contributions paid to the insurance company are used to purchase deferred or immediate annuities for individual participants. As defined in the FASB ASC glossary, an *annuity contract* is a contract in which an insurance company unconditionally undertakes a legal obligation to provide specified benefits to specific individuals in return for a fixed consideration or premium. This arrangement is irrevocable and involves the transfer of significant risk from the plan to the insurance company. Generally, allocated contracts are excluded from the plan's financial statements.

.125 An *unallocated contract*, as defined in the FASB ASC glossary, is a contract with an insurance company under which related payments to the insurance company are accumulated in an unallocated fund to be used to meet benefit payments when employees retire, either directly or through the purchase of annuities. Funds in an unallocated contract may also be withdrawn and otherwise invested. Unallocated funding ordinarily is associated with a group deposit administration contract and an immediate participation guarantee contract. For investment purposes, unallocated funds may be comingled in a general or pooled separate account or held in an individual separate account. These contracts generally should be included in the plan's financial statements

.126 On March 4, 2010, the DOL issued Advisory Opinion 2010-01A on whether a specific annuity contract, as described in the Advisory Opinion, is a fully allocated contract for annual reporting purposes within the meaning of 29 CFR 2520.104-44(b)(2) and the Form 5500 annual return/report instructions. The DOL Advisory Opinion concluded that, based on the facts and circumstances set forth in the Advisory Opinion, the specified annuity contract is not a fully allocated contract within the meaning of 29 CFR 2520.104-44(b)(2). The Advisory Opinion can be viewed at www.dol.gov/ebsa/regs/aos/ao2010-01a.html

Accounting for Uncertainty in Income Taxes

.127 For many calendar-year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This ASU affects all nongovernmental entities, and the disclosure amendments apply only to nonpublic entities. Following are the four main provisions:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.

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- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate.

.128 FASB ASC 740-10 clarifies the accounting and provides implementation guidance for uncertainty in income taxes recognized in an entity's financial statements. In certain situations, there may be uncertain tax positions associated with the determination of unrelated business taxable income (UBTI). Refer to the full text of ASU No. 2009-06 at www.fasb.org.

Considerations for Employee Benefit Plans

.129 A plan's status as tax-exempt is a tax position that may be subject to uncertainty. If the plan has entered into a correction program, such as the Employee Plans Compliance Resolution System, such a program may aid the plan administrator in assessing whether there is uncertainty with respect to the plan's tax exempt status. Such programs do not apply to tax exempt welfare benefit plans.

.130 Although qualified benefit plans are not generally subject to taxation, certain activities of a qualified plan may be taxable. In general, UBTI of a tax-exempt entity is subject to taxation. UBTI is

- gross income derived from an unrelated trade or business that is regularly carried on, less
- allowable deductions directly connected with the trade or business.

.131 With respect to qualified retirement plans, *unrelated trade or business* is defined as any trade or business regularly carried on by the trust or by a partnership or S corporation of which the trust is a member. This means that a qualified plan can have UBTI due to its investments. For tax-exempt welfare plans, UBTI includes the preceding definition. In addition, such plans may be subject to UBTI on their investment income, if their assets exceed certain allowable reserves.

.132 Nonleveraged investments, such as government securities, stocks and debt instruments of noncontrolled corporations, mutual funds and insurance company annuity contracts, do not typically generate UBTI. However, other nonleveraged investments, such as investments in partnerships, real estate investment trusts, loans or mortgages, and options to buy or sell securities such as short sales or repurchase agreements, may generate UBTI. Due to the nature of their investments, the most common plans that generate UBTI are health and welfare plans and defined benefit pension plans. With the increase, however, of such investments held by defined contribution plans, such plans may begin to be subject to UBTI also.

.133 In addition, UBTI may be generated when a plan uses debt to purchase an investment or if the plan purchases a partnership that uses debt to purchase an investment. Passive investments, such as these, may generate UBTI.

.134 Chapter 12 of AICPA Audit and Accounting Guide *Employee Benefit Plans* provides guidance for auditing plans that have UBTI.

Related Disclosures

.135 FASB ASC 740-10-50-15 states that all entities should disclose all of the following at the end of each annual reporting period presented:

- The total amounts of interest and penalties recognized in the statement of operations and the total amounts of interest and penalties recognized in the statement of financial position

- For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date:
  - The nature of the uncertainty
  - The nature of the event that could occur in the next 12 months that would cause the change
  - An estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made
- A description of tax years that remain subject to examination by major tax jurisdictions[9]

.136 The following is an illustrative disclosure of a defined contribution plan's tax status and uncertain tax position:

> The Internal Revenue Service has determined and informed the company in a letter dated August 30, 20XX, that the plan and related trust are designed in accordance with applicable sections of the IRC. Although the plan has been amended since receiving the determination letter, the plan administrator and the plan's tax counsel believe that the plan is designed and is currently being operated in compliance with the applicable requirements of the IRC and therefore believe that the plan is qualified and the related trust is tax-exempt.
>
> Accounting principles generally accepted in the United States of America require plan management to evaluate tax positions taken by the plan and recognize a tax liability if the plan has taken an uncertain position that more likely than not would not be sustained upon examination by the [*Identify applicable taxing authorities*]. The plan administrator has analyzed the tax positions taken by the plan, and has concluded that as of December 31, 20X1, there are no uncertain positions taken or expected to be taken that would require recognition of a liability or disclosure in the financial statements. The plan is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. The plan administrator believes it is no longer subject to income tax examinations for years prior to 20XX.

Other Auditing Issues and Developments

Client Acceptance and Continuance

.137 Paragraph .27 of Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), provides that policies and procedures should be established for the acceptance and continuance of client relationships and specific engagements. Such policies and procedures should provide the audit firm with reasonable assurance that it will undertake or continue relationships and engagements only when the firm

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so; and
- can comply with legal and ethical requirements.

.138 The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

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[9] AICPA TIS section 5250.15, "Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions" (AICPA, *Technical Practice Aids*), clarifies that the disclosures required by paragraph 15*c–e* of FASB ASC 740-10-50 remain in effect (if applicable), regardless of whether the entity has any uncertain tax positions. Typically, plan tax years will remain open for three years however this may differ depending upon the tax situations of each individual plan. Plan sponsors may consider consulting with their tax specialist to determine the applicable open tax years for their plan.

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.139 The following is a list of risk factors that engagement teams might consider during their client acceptance and continuance discussions related to an employee benefit plan engagement:

- Ineffective monitoring by management (for example, lack of oversight by plan management of outside providers [such as lack of review of reconciliations of trust assets to participant accounts or no independent records maintained by the sponsor to periodically check information provided by the custodian] or an ineffective plan oversight committee)
- Complex or unstable organizational structure (for example, turnover of plan management, oversight committee members, or outside service providers or difficulty in determining what individuals or committees have oversight or fiduciary responsibility for the plan)
- Weak financial reporting skills, failure by the plan administrator or plan management to take appropriate responsibility for the financial statements, or the plan has a material weakness or significant deficiency in its financial reporting process
- Significant related-party transactions or transactions with parties in interest, or history of engaging in prohibited transactions (for example, involvement in nonexempt transactions or events or activities [violations of laws, regulations, or plan provisions] that could cause loss of tax-exempt status)
- Plan invests in securities that do not have a readily determinable market value (such as limited partnerships and nonpublicly traded employer securities), specialized, or unique investments, or engages in securities lending (regardless of the scope of the audit) and management lacks the proper oversight and understanding of such investments, including valuation
- The use of service providers that do not provide a type 2 Statement on Standards for Attestation Engagements (SSAE) No. 16 report (formerly SAS No. 70 report, also known as a Service Organization Control [SOC] 1 report)
- The plan is inherently more complex (such as, health and welfare plans and leveraged ESOPs) and the engagement team lacks the technical skills that are necessary to audit such a plan
- Other inherent risk factors, such as electronic payroll or human resources systems, complex decentralized control environment, or in-house processing of complex transactions (such as benefit calculations and claims)
- The plan has significant issues with regulatory agencies, pending enforcement matters, or other investigations

Refer to the "403(b) Plan Considerations" section of this alert for unique considerations related to 403(b) plans.

Service Organizations

.140 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324) has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attestation standard and an auditing standard to better reflect the nature of the work being performed. SSAE No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), contains the requirements for performance of the examination and reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, and earlier implementation is permitted. Once effective, auditors that are engaged to report on a service organization's controls will no longer follow the guidance in AU section 324 but rather will follow the attestation standards when performing these engagements (hereinafter, referred to as SSAE No. 16 reports).

.141 A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or

more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012.

.142 An auditor that audits the financial statements of an entity that uses a service organization is known as a user auditor. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324.

Changes to SAS No. 70 Reports and the Effect on Employee Benefit Plans

.143 A service auditor may be engaged to provide the following two types of SSAE No. 16 reports:

- *Type 1 report*. A report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date.
- *Type 2 report*. A report that is the same as a type 1 report but also includes (1) the service auditor's opinion on the operating effectiveness of the controls and (2) a description of the service auditor's tests of the operating effectiveness of the controls and the results of those tests.

.144 The AICPA has developed a new alert, *Service Organizations: New Reporting Options*, which provides user auditors with an overview of the changes to SAS No. 70 and introduces a series of three different SOC reports (SOC 1, SOC 2, and SOC 3). This series encompasses the new SSAE No. 16, which retains the original purpose of SAS No. 70, and adds two new reporting options. The SOC 1 report is another way to refer to the SSAE No. 16 report. You can find the new alert at www.cpa2biz.com with the code 0224811.

Considerations for Employee Benefit Plans

.145 Internal control of a benefit plan consists of the controls at the sponsor as well as the controls at applicable service and subservice organizations that perform significant plan functions including but not limited to processing of participant-level transactions such as contributions and distributions, investment custody and valuation, and execution of investment transactions. SSAE No. 16 reports may be useful in providing user auditors with a sufficient understanding of controls at the service organization to assess the risks of material misstatement in accordance with AU section 314.

.146 It is not uncommon for the service organization's SSAE No. 16 report to cover only some of the services used by the plan (for example, the report might cover custodial services but not allocation services) or not to cover activities performed by subservice organizations (for example, the report might not cover services performed by an investment pricing service). The subservice organization may be a separate entity from the service organization or may be related to the service organization. For example, 401(k) record keepers often exclude the related data processing center from their SSAE No. 16 reports. The independent auditor's report included in the SSAE No. 16 report will typically include language that the report does not cover certain significant service or subservice organizations or systems. For less significant service or subservice organizations or systems, this language will not be included in the auditor's report, but will be described elsewhere in the report. In these situations, auditors would gain an understanding of the controls related to the services not covered by the service or subservice organization that are part of the plan's information system. If the user auditor does not have sufficient information to assess control risk as low or moderate, the plan auditor may decide to perform additional tests of the service or subservice organization's controls or perform additional audit procedures on the plan's financial statements. The auditor may obtain a copy of the subservice organization's SSAE No. 16 report if one was issued.

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.147 The AICPA is in the process of updating the Practice Aid *SAS No. 70 Reports and Employee Benefit Plans*. This Practice Aid provides guidance to user auditors about the use of SSAE No. 16 reports in the audit of employee benefit plans. Be alert for the issuance of this practice aid.

> **Help Desk**: See chapter 6 of AICPA Audit and Accounting Guide *Employee Benefit Plans* for further guidance regarding the use of service organizations.

Supplementary and Other Information Related to Financial Statements

.148 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.149 ERISA requires a plan's financial statements to include a note explaining differences, if any, between amounts reported in the financial statements and the amounts reported in the Form 5500, Schedule H. If, upon review of the Form 5500 subsequent to the issuance of the plan's financial statements, the auditor identifies any such differences, he or she may consider reissuing the auditor's report, dual-dated with respect to the note explaining the differences. If the differences represent a material inconsistency or misstatement of fact in the preparation of the Form 5500, then the guidance in AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), is appropriate.

.150 SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information.[10] *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

SAS No. 118 Considerations Specific for Employee Benefit Plans

.151 Information in the Form 5500 may be relevant to an independent audit or to the continuing propriety of the auditor's report. In accordance with AU section 550, the auditor should read the other information in the Form 5500 in order to identify material inconsistencies, if any, with the audited financial statements when such financial statements are accompanied by the other information. The auditor should make appropriate arrangements with management to obtain the other information prior to the report release date. If it is not possible to obtain all of the other information prior to the report release date, the auditor should read such other information as soon as practicable. AU section 550 also addresses the auditor's responsibilities when the auditor (*a*) identifies material inconsistencies (*b*) identifies material inconsistencies prior to the report release

[10] *Required supplementary information* is defined in paragraph .04 of AU section 558, *Required Supplementary Information* (AICPA, *Professional Standards*). Also see the section of this alert beginning at paragraph .163.

date, (*c*) obtains other information subsequent to the report release date, or (*d*) becomes aware of material misstatements of fact.

Reports Issued Prior to Form 5500 Filing

.152 The auditor may encounter situations in which the financial statements and auditor's report are issued prior to the auditor's review of the Form 5500. If such a situation occurs, the plan administrator should not attach the financial statements and auditor's report to the filing without the auditor's review of the filing on Form 5500. When the engagement letter is prepared, it may include a statement that if the financial statements and auditor's report are issued prior to the filing of Form 5500, those statements and report should not be attached to the filing without it being reviewed by the auditor. The auditor may also wish to consider including a statement in the transmittal letter to the client indicating that the financial statements and auditor's report, as presented, are not to be attached to the Form 5500 filing without the auditor's review of that filing.

Supplementary Information in Relation to the Financial Statements as a Whole

.153 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of GAAS, *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

Supplemental Schedules Relating to ERISA and DOL Regulations

.154 ERISA and DOL regulations require additional information to be included as schedules to the financial statements. Some of this information is required to be covered by the auditor's report. Paragraphs .05–.08 of AU section 551 establishes procedures to determine whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. Such procedures include specific written representations that the auditor should obtain from management. In order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should determine that all of the following conditions are met:

a. The supplementary information was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.

b. The supplementary information relates to the same period as the financial statements.

c. The financial statements were audited, and the auditor served as the principal auditor in that engagement.

d. Neither an adverse opinion nor a disclaimer of opinion was issued on the financial statements. (When reporting under the limited scope audit exemption, see the section "Limited-Scope Audits Under DOL Regulations" that follows.)

e. The supplementary information will accompany the entity's audited financial statements, or such audited financial statements will be made readily available by the entity.

.155 Paragraph .07 of AU section 551 states that in addition to the procedures performed during the audit of the financial statements, in order to opine on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should perform the following procedures using the same materiality level used in the audit of the financial statements:

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a. Inquire of management about the purpose of the supplementary information and the criteria used by management to prepare the supplementary information, such as an applicable financial reporting framework, criteria established by a regulator, a contractual agreement, or other requirements

b. Determine whether the form and content of the supplementary information complies with the applicable criteria

c. Obtain an understanding about the methods of preparing the supplementary information and determine whether the methods of preparing the supplementary information have changed from those used in the prior period and, if the methods have changed, the reasons for such changes

d. Compare and reconcile the supplementary information to the underlying accounting and other records used in preparing the financial statements or to the financial statements themselves

e. Inquire of management about any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information

f. Evaluate the appropriateness and completeness of the supplementary information, considering the results of the procedures performed and other knowledge obtained during the audit of the financial statements

g. Obtain written representations from management

i. that it acknowledges its responsibility for the presentation of the supplementary information in accordance with the applicable criteria

ii. that it believes the supplementary information, including its form and content, is fairly presented in accordance with the applicable criteria

iii. that the methods of measurement or presentation have not changed from those used in the prior period or, if the methods of measurement or presentation have changed, the reasons for such changes

iv. about any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information

v. that when the supplementary information is not presented with the audited financial statements, management will make the audited financial statements readily available to the intended users of the supplementary information no later than the date of issuance by the entity of the supplementary information and the auditor's report thereon

.156 Paragraph .09 of AU section 551 requires the auditor to report on the supplementary information in either (1) an explanatory paragraph following the opinion paragraph in the auditor's report on the financial statements or (2) in a separate report on the supplementary information.[11] The explanatory paragraph or separate report should include the following elements:

a. A statement that the audit was conducted for the purpose of forming an opinion on the financial statements as a whole

b. A statement that the supplementary information is presented for purposes of additional analysis and is not a required part of the financial statements

c. A statement that the supplementary information is the responsibility of management and was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements

[11] Paragraph .10 of AU section 551, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*), addresses how to report when the audited financial statements are not presented with the supplementary information. That is, in addition to the elements to be included in an explanatory paragraph (see AU section 551 paragraph .09), the report should include a reference to the report on the financial statements, the date of that report, the nature of the opinion expressed on the financial statements, and any report modifications.

d. A statement that the supplementary information has been subjected to the auditing procedures applied in the audit of the financial statements and certain additional procedures, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the financial statements or to the financial statements themselves and other additional procedures, in accordance with auditing standards generally accepted in the United States of America

e. If the auditor issues an unqualified opinion on the financial statements, and the auditor has concluded that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, a statement that, in the auditor's opinion, the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole

f. If the auditor issues a qualified opinion on the financial statements and the qualification has an effect on the supplementary information, a statement that, in the auditor's opinion, except for the effects on the supplementary information of (refer to the paragraph in the auditor's report explaining the qualification), such information is fairly stated, in all material respects, in relation to the financial statements as a whole

.157 When the auditor's report on the audited financial statements contains an adverse opinion or disclaims an opinion and the auditor has been engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to such financial statements as a whole, the auditor is precluded from expressing an opinion on the supplementary information. When permitted by law or regulation, the auditor may withdraw from the engagement to report on the supplementary information. If the auditor does not withdraw, the auditor's report on the supplementary information should state that because of the significance of the matter disclosed in the auditor's report, it is inappropriate to, and the auditor does not, express an opinion on the supplementary information. When reporting under the limited scope audit exemption, see the following section of this alert "Limited-Scope Audits Under DOL Regulations."

.158 The date of the auditor's report on the supplementary information in relation to the financial statements as a whole should not be earlier than the date on which the auditor completed the procedures required in paragraph .07 of AU section 551.

Help Desk: Plans that are required to file Form 11-K are considered issuers and should submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB. Accordingly, when reporting on supplemental schedules in a Form 11-K audit, AU section 551, *Reporting on Information in Auditor-Submitted Documents* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), should be followed.

.159 When additional information is presented on which the auditor does not express an opinion, the information should be marked as unaudited or should refer to the auditor's disclaimer of opinion. The exhibit of AU section 551 provides illustrative reports that the auditor may use when the auditor has expressed a qualified or adverse opinion or disclaims an opinion on the financial statements.

.160 If the auditor concludes, on the basis of the procedures performed, that the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose appropriate revision of the supplementary information. If management does not revise the supplementary information, the auditor should either (*a*) modify the auditor's opinion on the supplementary information and describe the misstatement in the auditor's report or (*b*) if a separate report is being issued on the supplementary information, withhold the auditor's report on the supplementary information.

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Limited-Scope Audits Under DOL Regulations

.161 When a plan administrator elects to limit the scope of the audit performed as permitted by 29 CFR 2520.103-8 of the DOL Rules and Regulations for Reporting and Disclosure under ERISA, the auditor is instructed by the plan administrator to limit the scope of testing of investment information prepared and certified by a qualified trustee, custodian or insurance company as complete and accurate.

.162 In situations in which a disclaimer arises from the exemption noted previously, the auditor is precluded from expressing an opinion that the supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole, in accordance with paragraph .11 of AU section 551.

> **Help Desk**: If the auditor is unable to obtain sufficient appropriate audit evidence regarding other noninvestment related information or investment information not covered by the certification then the standard form of limited scope report may not be appropriate. Also, it likely will not be appropriate for the auditor to opine on the form and content of the supplemental schedules as presented in compliance with the DOL's Rules and Regulations for Reporting and Disclosure under ERISA.

Required Supplementary Information

.163 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558), addresses the auditor's responsibility with respect to required supplementary information. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Employee benefit plan financial statements do not contain required supplementary information and therefore this SAS would not be applicable to plans.

Use of Electronic Confirmations

.164 Confirmations are undertaken to obtain sufficient appropriate audit evidence from third parties about financial statement assertions made by management. In a highly automated environment, auditors may face challenges in the confirmation process and therefore need to carefully manage the confirmation process and refrain from accessing information available to clients. It is important to note that an auditor's online inquiry of a third party's database does not meet the auditor's confirmation responsibility under AU section 330, *The Confirmation Process* (AICPA, *Professional Standards*). Instead, such online inquiry constitutes an alternative procedure. Refer to the full text of AU section 330 and 9330, *The Confirmation Process—Auditing Interpretations of Section 330* (AICPA, *Professional Standards*), for guidance when using electronic confirmations. As discussed in paragraph 7.16 of the Audit and Accounting Guide *Employee Benefit Plans*, a certification does not constitute confirmation.

.165 In addition to challenges with confirmation inquiries, when confirming investment existence and ownership with third party custodians or trustees in a full scope audit, auditors are often faced with challenges regarding the method of response. The challenges relate to electronic responses and those that generally do not address all requests contained in an auditor's inquiry. AU section 330, requires an active response from a third party. Guidance related to this is available in AU section 9330. AU section 9330 states that electronic responses are not precluded and highlights considerations to assist auditors with their determination of the reliability of the information obtained through the confirmation process, including consideration of the risk that

- the information obtained may not be from an authentic source;
- a respondent may not be knowledgeable about the information to be confirmed; or
- the integrity of the information may have been compromised.

Form 11-K Audits

.166 Plans that are required to file Form 11-K are deemed to be issuers under SOX and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the PCAOB. Employee stock purchase, savings, and similar plans with interests that constitute securities registered under the Security Act of 1933 are required by the SEC to file Form 11-K pursuant to Section 15(d) of the Security Exchange Act of 1934. Form 11-K must be filed with the SEC within 90 days after the end of the plan's fiscal year-end, when it is filed separately and not as an exhibit to Form 10-K. However, if a plan is subject to ERISA, and files plan financial statements and schedules prepared in accordance with the financial reporting requirements of ERISA, the Form 11-K filing deadline is increased to 180 days after the plan's fiscal year-end. In addition, two separate audit reports, one referencing PCAOB standards for the Form 11-K filing with the SEC and a separate report referencing GAAS for the DOL filing, are required.

> **Help Desk**: Instructions for completing Form 11-K can be found under topic 15 of the SEC manual located on the SEC website at www.sec.gov.

.167 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB website at www.pcaob.org for information about its activities.

Recent PCAOB Pronouncements and Related Guidance	
Public Company Accounting Oversight Board (PCAOB) Release No. 2010-06, *Report On Observations of PCAOB Inspectors Related to Audit Risk Areas Affected By the Economic Crisis*[12] Issue Date: September 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This release summarizes inspection observations of audits of financial institutions and other companies during the economic crisis. This release was issued to inform the public about the audit risks and challenges that the PCAOB has identified through its inspection program as a result of the disruption in credit and financial markets and the broader economic downturn.
PCAOB *Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards*, Auditing Standard Nos. 8–15 Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB Standards)	The new standards can be found in appendixes 1–8 of PCAOB Release No. 2010-004 at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf
Amendments to PCAOB Standards Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	In conjunction with the PCAOB's adoption of Auditing Standard Nos. 8–15, the PCAOB also adopted a number of related amendments to PCAOB standards. The amendments can be found in appendix 9 of PCAOB Release No. 2010-004 at http://pcaobus.org/Rules/Rulemaking/Docket%20026/Release_2010-004_Risk_Assessment.pdf

[12] See paragraph .93 in this alert for additional information on the *Report on Observation of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*.

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Recent PCAOB Pronouncements and Related Guidance	
PCAOB Staff Audit Practice Alert No. 7, *Auditor Considerations of Litigation and Other Contingencies Arising From Mortgage and Other Loan Activities* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.07) Issue Date: December 2010 (Applicable to audits conducted in accordance with PCAOB standards)	The PCAOB staff has taken this action in light of reports alleging that companies may have misrepresented the quality of many loans sold for securitization and that those companies could be required to repurchase the affected mortgages, creating an exposure for the banking industry of up to $52 billion. Additionally, allegations have surfaced that irregularities in the foreclosure process could result in further losses. The practice alert advises auditors that these mortgage- and foreclosure-related activities or exposures could have implications for audits of financial statements or of internal control over financial reporting. These implications might include accounting for litigation or other loss contingencies and the related disclosures.

Defined Benefit Plans

Actuarial Reports for Defined Benefit Plans

.168 Several economic and demographic assumptions are used in actuarial valuations for defined benefit plans to determine funding requirements and the actuarial present value of accumulated plan benefits in accordance with the guidance in FASB ASC 960. One of the most significant economic assumptions is the discount rate. Two approaches exist that can be used to select the discount rate. The most commonly used approach is to reflect the long-term expected rate of return on assets. This amount is generally stable from one year to the next. This assumption would reflect anticipated growth of the actual underlying investments in the pension trust. Many employers are changing the mix of investments that have been historically used. For employers that are changing their mix of assets, the actual history of returns is not as relevant as new expectations for the new mix of assets.

.169 Historically, when an approach of looking at the long term expected return was used, the rate selected had generally been the same as that used for funding purposes. However, the Pension Protection Act of 2006 (PPA) has changed the funding rate. The funding rate is no longer an appropriate rate for use in the plan's financial statements. Plans using expected return on plan assets as the basis for choosing the discount rate will need to have a benchmark other than the PPA funding rate. One of the most common approaches has been to use the expected return on plan assets that the employer uses when following the guidance in FASB ASC 715, *Compensation—Retirement Benefits*. It is important to note that this is not the discount rate used for purposes of applying FASB ASC 715. The discount rate and the expected return are separate and distinct rates. Therefore, auditors will need to take care when determining if the proper rate is disclosed in the benefit plan's financial statements.

.170 The second approach that may be used to select the discount rate used to determine the present value of accumulated plan benefits is to select a rate that reflects an insurance company's purchase rates as of the benefit information date. Because this is a settlement type of rate, it may be similar to (but not necessarily the same as) the discount rate used for the financial statements of the plan sponsor. A discount rate selected on this basis can be expected to change from year to year to reflect changes in the long term interest rate markets.

.171 It should be noted that if a plan has used one basis to select its discount rate and then changes to a different basis, a change in accounting principle may occur. For example, if a plan had used the funding rate prior to PPA (a long-term return basis) and then changes to a settlement type rate (such as the discount rate described in FASB ASC 715), it might be considered a change in accounting principle rather than a change in estimate. Consider the guidance in FASB ASC 250, *Accounting Changes and Error Corrections*, when making this determination.

.172 The most significant demographic assumptions used to determine the actuarial present value of accumulated plan benefits include mortality rates, retirement age, form of payment, or type of benefit elections and cash balance crediting rates, if applicable. With the increase in life expectancies, the mortality assumption should include improvements to longevity that were not included in earlier tables.

.173 Certain mortality tables used by actuaries include the 1983 Group Annuity Mortality (GAM), 1994 GAM, Uninsured Pensioner Mortality (UP) 1994, and Retired Pensioner Mortality (RP) 2000 tables. Auditors may consider challenging the use of such tables for purposes of determining the plan's benefit obligation beginning in 2007. For 2007 calendar year plans and beyond, a new mortality table is required as part of the minimum required contribution calculation. This table, which is based on the RP 2000 mortality table, has replaced the 1983 GAM table. Many actuarial reports will refer to this table as the RP 2000 Combined Mortality Table with projections as specified by IRS Regulation 1.412(1)(7)-1. It has been common practice to use the same mortality table for the financial statements of the plan as is required for minimum funding purposes. It can therefore be expected that the RP 2000 table with or without the IRS required projections will be used frequently for 2009 valuations. It is possible that the use of the 1983 GAM table, in limited circumstances, may continue to be acceptable depending on the plan's experience; however, most plans will be changing to use the 1994 GAM, UP 1994, or the recent RP 2000 tables for their mortality assumptions. It is expected that plan sponsors will consider the demographics of their participant population prior to utilizing a mortality table in determining the actuarial present value of accumulated plan benefits.

.174 The medical trend assumption is unique to postretirement health and welfare plans. This assumption is intended to project the current cost of health care benefits to future periods when those benefits will be paid. Health care costs have traditionally increased at a faster rate than general inflation. In addition to general inflation, health care costs are affected by increased utilization of plan benefits, rising cost of medical technology, and the leveraging effect of plan provisions such as co-pays and deductibles. Taken together, these factors contribute to cost increases well above the rate of general inflation. Most actuaries assume that these excess cost increases will continue in the near term but will ultimately merge with general inflation rates. Therefore, a common approach is to assume a higher trend rate for the current year and grade down to the general inflation rate after several years. An example is a trend rate of 9 percent for 2009 grading down by 0.50 percent each year until the ultimate rate of 5 percent is reached for 2017 and beyond. Auditors should question trend assumptions that reflect only general inflation for all years or that grade down to general inflation too quickly. For example, if the trend assumption is 8 percent for 2009 and grades to 5 percent in 2011, the auditor will want to obtain support for the rapid decline.

.175 Regardless of the assumption used, each assumption must be individually reasonable. Plan management ordinarily should review actual plan experience with assumptions used periodically to determine if any changes should be made. The following may also be considered as plan auditors review actuarial valuations:

- *Trends and nature of benefit distributions* (for example, lump sum versus annuity). A plan that predominantly pays lump sum benefits may have a higher obligation than an equivalent plan that pays annuities. To properly value the plan's liabilities, assumptions must be used to reflect the cost of the lump sum benefits. If only assumptions that reflect annuities exist, the lump sum benefits may be undervalued.
- *Whether a shift in the plan population has occurred over time*. This could warrant a different assumption for turnover or retirement, for example, if participants are retiring much earlier or later than assumed.
- *Whether recent plan mergers or acquisitions have occurred*. In the case of a plan merger, all assumptions would be reviewed for their continued reasonableness because the assumptions used for one plan may not be appropriate for the plan being merged.
- *Whether changes to any plan benefit formula or a freezing of the plan has occurred*. Changes in plan benefits available may affect anticipated turnover and retirement patterns. These assumptions would be reviewed if the plan is amended to change benefits.
- *Whether consistent gains and losses are generated each year*. If yes, this may indicate that one or more of the assumptions are not reasonable based on actual experience.

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.176 When reviewing an actuarial report, consideration may be given to the following:

- Consistency of benefits accumulated each year (auditors would expect changes if a plan merger, acquisition, a significant plan provision change, or changes to the underlying assumptions have occurred).
- Benefit payments in the roll forward of accumulated plan benefits, which should match the amount per the statement of changes in net assets (to properly match these amounts, it is necessary to understand if the beginning of the year or end of the year information is used for the actuarial valuation).
- The asset value on the financial statements, which should match the asset value shown in the actuarial report.
- Inclusion of the effect of a change in plan provisions and the effect of merger, spin-off, or acquisition.

.177 It is also important to note that the assumption of salary increases may not be relevant because the disclosure of the actuarial present value of accumulated plan benefits does not take into account future salary increases. It may have some relevance if the actuary does not have or maintain salary histories for the plan participants and the salary increase assumption is used to estimate prior salary histories.

Help Desk: In light of funding pressures in the current economic environment, the risk that the plan's benefit obligation is understated due to inappropriate selection of an actuarial assumption or inaccurate or incomplete census data provided to the actuary may be a significant risk.

The calculation of the plan's benefit obligation can be very sensitive to actuarial assumptions and census data. Accordingly, it is important (*a*) to gain comfort regarding the reasonableness of the actuarial assumptions used, and (*b*) to properly test the census data in order to gain comfort that the calculation of the benefit obligation is based on correct census data and reasonable assumptions.

The Use of Beginning of Year Benefit Information Date

.178 The presentation of the financial statement information and the notes are affected by the benefit information date selected for disclosure. The preferred approach is to use an end-of-year benefit information date. If end-of-year is presented, the present value of accumulated plan benefits will be as of the same date as the net assets. In this case, at a minimum, two statements of net assets available for benefits and one statement of changes in net assets are presented. In addition, two corresponding statements (or disclosure in the notes) of the present value of accumulated plan benefits and one statement of changes also are presented. Examples of this are shown in exhibits D-1–D-4 of Audit and Accounting Guide *Employee Benefit Plans*.

.179 However, if beginning-of-year benefit information is used, the date of the benefit information in the actuarial report may not match the date that net assets are presented. For example, for financial statements presented as of December 31, 2008, and December 31, 2007, the actuarial valuation will be as of January 1, 2008. For the benefit information to match the statement of net assets, the present value of accumulated plan benefits should be presented as of December 31, 2007 (one day earlier). Typically, this will not cause a material misstatement unless a plan amendment was adopted on or after January 1, 2008, with a January 1, 2008, effective date. In that case, the effect of the amendment must be removed. As shown in Audit and Accounting Guide *Employee Benefit Plans*, when beginning-of-year benefit information is used, comparative statements of net assets and comparative statements of changes would be presented. Only a single year presentation of accumulated plan benefits is required with a roll forward of the change from the prior year. Examples of this are shown in exhibits D-1 and D-7–D-8 of Audit and Accounting Guide *Employee Benefit Plans*.

Effect of the PPA on Defined Benefit Plans

.180 The PPA has affected many aspects of plan design, administration, and funding. For defined benefit plans, the PPA focuses on the funded percentage as the trigger point to activate additional funding requirements and benefit limitations. These rules are very complex and this discussion will not address many of those complexities but rather will provide an overview of the key features.

.181 New minimum funding standards were fully operational for 2008 plan years. Minimum funding standards are established based on a plan's funded status. The funding target is the present value of accrued benefits. PPA defines the ratio of plan assets to the funding target as the adjusted funding target attainment percentage (AFTAP). If the assets equal the present value of accrued benefits, the plan's AFTAP will be 100 percent. The minimum required contribution for plans with an AFTAP of 100 percent or greater will be the plan's normal cost. This is the actuarially determined amount necessary to fund the benefits that have accrued in the current year. This minimum contribution could be reduced to zero if the excess of the assets over the funding target exceeds the plan's normal cost for the year. For plans with an AFTAP of less than 100 percent, the minimum required contribution will be the plan's normal cost plus an additional payment that will amortize the shortfall over 7 years plus, if applicable, the amortization of any funding waivers over a 5-year period.

.182 Funding waivers may be requested in cases of business hardship. Application for a funding waiver must be made within two-and-a-half months of the plan year-end. The plan may not be amended to increase benefits while a funding waiver is in effect. The IRS cannot grant extension of the funding waiver amortization period. If granted, waivers generally permit a plan sponsor to pay the ERISA minimum contribution over a five-year period. The auditor may need to ascertain whether the plan is a going concern for a reasonable period of time (not to exceed one year beyond the date of the financial statements being audited).

.183 As in prior years, the minimum required contribution will be part of the actuarial report. For financial statement purposes, the aforementioned minimum required contributions are accrued and any excess amounts received after year-end would be considered a Type 2 subsequent event unless evidence exists of a formal commitment as of the balance sheet date. The contributions receivable for the financial statements should include the amounts paid in the subsequent period and may be adjusted by the effective interest rate used. For plans when the plan sponsor has not made the final required contribution as of the date of the plan's filing, the receivable amount should include the amount required to be paid, based on the best estimate of when the payment will be made, as of the plan's year-end.

.184 Each year the actuary is required to certify to the plan's funded percentage. Plans with a funding percentage below 80 percent will be required to implement certain benefit limitations. Further limitations will be required when the AFTAP falls below 60 percent. Plans with an AFTAP above 60 percent but less than 80 percent may not be amended to provide additional or increased benefits. They must also place a limit on accelerated benefits such as lump sums and annuity purchases. This limit is 50 percent of the full amount allowed by the plan. If the AFTAP falls below 60 percent, the plan must freeze the accrual of all future benefits until such time as the percentage increases to over 60 percent. The plan will also not be allowed to make any accelerated payments. The auditor will need to determine if the plan is being operated in accordance with any limitations that apply based on the aforementioned rules and consider the need for disclosure of such limitations in the notes to the financial statements of the plan.

.185 The PPA imposed new disclosure requirements on plan sponsors of defined benefit plans, including sponsors of cash balance plans. If the plan sponsor maintains an intranet website, they are required to post the plan's Form 5500 actuarial information on the sponsor's intranet website. The PPA amendment also requires the DOL to post the plan's actuarial information on its website. The statutory requirements that apply to plan sponsors and the DOL are the same except the DOL is required to post the plan's Form 5500 actuarial information on its website within 90 days after the date the plan's Form 5500 is filed with the DOL.

.186 The statute does not contain a deadline for a plan sponsor to post this information on its intranet; however, if plan sponsors have not yet posted the plan's actuarial information for the 2008 year, they may want take action quickly to meet this requirement.

> **Help Desk:** The DOL has established a website that allows the public to search for a plan sponsor's Form 5500 actuarial information: www.dol.gov/ebsa/actuarialsearch.html.

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Health and Welfare Plans

Tax-Advantaged Accounts for Health Care Expenses

.187 The IRC provides for the following types of tax-advantaged accounts that can be used to pay for unreimbursed medical expenses in defined-contribution arrangements: health care Flexible Spending Accounts (FSAs), Health Reimbursement Accounts (HRAs), Health Savings Accounts (HSAs), and Medical Savings Accounts (MSAs). Unreimbursed medical expenses typically include deductibles, copayments, and goods or services not covered by insurance. Although these accounts have some common features, they also differ in several important respects.

.188 Congressional Research Service issued a report in June 2010 that provides a brief summary of the four accounts and compares them with respect to eligibility, contribution limits, use of funds, and other characteristics: http://assets.opencrs.com/rpts/RS21573_20100618.pdf.

Health Care Reform

.189 In March 2010, Congress passed two pieces of legislation designed to reform the U.S. health care system. The Patient Protection and Affordable Care Act (PL 111-148) was quickly followed by the Health Care and Education Reconciliation Act of 2010 (PL 111-152). PL 111-152 amended several portions of the first act and added new provisions of its own. These two acts are collectively referred to as the Affordable Care Act. These two pieces of legislation were designed to reform the U.S. health care delivery system. Although the legislation generally deals with the health care system, it does contain many revisions to the IRC which may affect plan design or operation. The Affordable Care Act contains provisions that affect both individuals and employers.

Help Desk: This alert describes many of the items in the Affordable Care Act applicable to individuals and employers; however, it is not an all-inclusive summary. Health reform is far-reaching and there is much uncertainty as to how health reform measures will affect the way health care entities will deliver services to their patients in the future and how they will be compensated for those services. In addition, ongoing litigation is challenging the Affordable Care Act.

Much has been written on the topic of health care reform. For example, the following websites provide information that may be helpful to readers:

- AICPA website www.aicpa.org/Research/HCR/Pages/HealthCareReform.aspx
- HealthCare website www.healthcare.gov/law/about/order/byyear.html
- Kaiser Family Foundation website www.kff.org/healthreform/upload/8061.pdf

.190 Under both prior law and the Affordable Care Act, employers who provide retiree prescription drug coverage that is at least as valuable as Medicare Part D are entitled to a subsidy from the federal government to help offset the cost of the coverage. This subsidy is not treated as income to the employer, and the employer is currently able to deduct the full cost of the retiree prescription drug coverage for income tax purposes (including the portion that is offset by the subsidy). Under the Affordable Care Act, for tax years beginning after December 31, 2012, companies will no longer be able to deduct the portion of the retiree prescription drug coverage cost that is subsidized by the federal government. Although companies will still be allowed to exclude the entire amount of the subsidy from their taxable income, companies will only be allowed to deduct the portion of the coverage that they pay with employer funds.

.191 In addition, the Affordable Care Act imposes an excise tax on high-value health plans (often referred to as "Cadillac" plans). Although this tax burden lies primarily on health insurance issuers, the tax is expected to affect many employers through increases in premiums or fees or both charged by insurance companies.

Help Desk: These law changes are expected to result in an increase in the total cost of retiree medical coverage. Consequently, many companies are already evaluating the potential effect of these law changes on the level of benefits offered by the Plan and the associated effect on contribution rates. For a discussion of how these changes are already affecting benefit plans, see www.shrm.org/Publications/HRNews/Pages/TaxingRetiree
Drugs.aspx.

Health Care Reform Requirements

.192 Health care reform presents challenges for employers given its many new requirements. Most of the current requirements that apply to all plans go into effect starting with plan years that begin on or after September 23, 2010. Employers who do not comply with health care reform's requirements may potentially be fined $100 per day, per employee (with limits on the penalty in the case of unintentional failures and for small employers).

.193 Following are some of the major new requirements for health-care benefit plans (as of December 2010), along with their respective effective dates. Numerous additional rules (not listed) apply to "nongrandfathered plans" (for example, new plans that go into effect after March 2010, as well as to existing plans that are modified in certain respects after March 2010).

Rules in effect for plan years beginning on or after September 23, 2010:

- Extend eligibility for dependent coverage (if offered) to employees' unmarried children who are not yet 26 years old, even if not otherwise a dependent for tax purposes
- No preexisting condition exclusions for children under age 19
- No lifetime maximum benefit on essential benefits
- Restricted annual limits on essential benefits
- Rescission of an individual's coverage prohibited

Rule in effect on January 1, 2011:

- No reimbursement in a health-care FSA, HRA, HSA, or MSA for over-the-counter drugs purchased without a prescription, except insulin

Rule in effect on January 1, 2012:

- W-2 reporting of the cost of health-care benefits (optional for 2011)

Rule in effect on January 1, 2013

- Employee contributions to health-care FSAs limited to $2,500 per year

Rules in effect on January 1, 2014:

- No exclusion from coverage due to preexisting conditions, regardless of the individual's age
- No annual dollar limits on benefits
- Large employers pay penalties for providing no coverage or inadequate coverage (employers with 50 or more full-time employees)

Rule in effect on January 1, 2018:

- Forty percent excise tax on high-cost plans (plans with a cost in excess of $10,200 for single coverage and $27,500 for family coverage)

.194 For welfare benefit plans subject to audit, these law changes present unique financial reporting issues that could affect a plan's reported obligations. Plan management should consider the effect of plan design and regulatory changes when developing their obligation estimates, including the effect of plan amendments and

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regulatory changes that go into effect after the measurement date. For example, the effect of plan amendments should be included in the computation of the expected and accumulated postretirement benefit obligations once they have been contractually agreed to, even if some provisions take effect only in future periods (see FASB ASC 965-30-35-7 for such requirement). Auditors will want to determine if obligations have been properly calculated, reported, and disclosed in the financial statements.

.195 Prior to 2011, some sponsors split their retired participants into a separate health and welfare plan. Standalone retiree-only health and welfare plans could be affected to a lesser extent by healthcare reform than a plan with active participants. Regardless, plan management will want to consult with their actuary as to the ultimate effect.

Terminating Trusts

.196 In practice, terminating trusts are more commonly encountered than terminating health and welfare plans. Factors affecting the decision to terminate a trust may include moving a funded plan to an unfunded plan status or to a fully insured plan, both of which (upon termination of the existing trust) may eliminate the ongoing requirement for a plan audit. It is typically recommended that the trust be legally dissolved to accomplish the desired results, because even though the trust may not be utilized, if not legally dissolved, the plan may still be considered funded and, if all other audit requirements are met, may need an audit.

.197 Consideration should be given to the timing of the trust termination and the time period covered by the financial statements. If the trust was in existence at any time during the year, and all other audit requirements are fulfilled (see paragraph A.26 and exhibit 5-3), then the plan's financial statements would need to cover the entire year, not just the time period the trust was in operation.

Deficiencies Found in Employee Benefit Plan Audits

.198 The AICPA, working with Employee Benefits Security Administration (EBSA), has made a concerted effort to improve the guidance and training available to auditors of employee benefit plans. The AICPA self-regulatory teams continue to be concerned about deficiencies noted on audits of employee benefit plans and practitioners need to understand that severe consequences can result from inadequate plan audits, including loss of membership in the AICPA and loss of the individual's state license to practice public accounting. EBSA statistics indicate a higher number of deficiencies when practitioners audit less than 25 plans. In addition, more deficiencies were noted in defined benefit plans, health and welfare plans, and multiemployer plans.

.199 Most commonly found deficiencies by the DOL relate primarily to auditing procedures associated with inadequate planning of the engagement and inadequate test work for participant data, contributions, investments, benefit payments, plan obligations, and party-in-interest transactions. Deficiencies are also commonly found in the auditor's report. In addition, errors and omissions are commonly found in required note disclosures and supplemental schedules.

> **Help Desk:** For a more comprehensive list of common deficiencies, see the practice tool "Common EBP Audit Deficiencies" issued by the AICPA EBPAQC at www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Resources/ToolsandAids/DownloadableDocuments/EBPAQC_Common_Audit_Deficiences.pdf.

Recent Pronouncements

Recent Auditing and Attestation Pronouncements and Related Guidance

.200 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.
Interpretation No.1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, AT sec. 9501 par. .01–.07) Issue Date: September 2010 (Interpretive publication)	For insured depository institutions (IDI) that require an examination of internal controls at the IDI level, this interpretation addresses whether the auditor can meet the integrated audit requirement when an IDI does not prepare financial statements for external distribution and, if so, how the auditor can report on the effectiveness of the IDI's internal control over financial reporting.
Interpretation No. 8, "Including a Description of Tests of Controls or Other Procedures and the Results Thereof, in an Examination Report," of AT section 101, *Attest Engagements*, (AICPA, Professional Standards, AT section 9101 par. .70–.72) Issue Date: July 2010 (Interpretive publication)	This interpretation addresses whether a practitioner performing an examination engagement under AT section 101 may include a description of tests of controls or other procedures, and the results thereof, in a separate section of the examination report, and includes relevant considerations in determining whether to do so.

Recent ASUs

.201 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC)	
Accounting Standards Update (ASU) No. 2011-01 (January 2011)	*Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*

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Recent Accounting Standards Updates	
ASU No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-28 (December 2010)	*Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-27 (December 2010)	*Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers (a consensus of the FASB Emerging Issues Task Force)*
Broad Transactions Area of FASB ASC	
ASU No. 2010-29 (December 2010)	*Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-26 (October 2010)	*Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-24 (August 2010)	*Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-23 (August 2010)	*Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-25 (September 2010)	*Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans (a consensus of the FASB Emerging Issues Task Force)*

Recently Issued Technical Questions and Answers

.202 The following table presents a list of nonauthoritative accounting, audit, and attest technical questions and answers recently issued by the AICPA. Recently issued questions and answers can be accessed at

www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Recently Issued Technical Questions and Answers **(AICPA,** ***Technical Practice Aids*****)**	
Accounting	
Technical Questions and Answers (TIS) section 6910.18 (Revised October 2010)	"Disclosure of an Investment in an Issuer When One or More Securities or One or More Derivative Contracts Are Held—Nonregistered Investment Partnerships"
TIS section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments"
Audit and Attest	
TIS section 9110.17 (July 2010)	"Application of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740-10 (previously, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*),

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Recently Issued Technical Questions and Answers **(AICPA, *Technical Practice Aids*)**	
	to Other Comprehensive Basis of Accounting (OCBOA) Financial Statements – Recognition and Measurement Provisions"
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"

Regulatory Developments

Timeliness of Remittance of Participant Contributions Remains an Enforcement Initiative for the EBSA

.203 The EBSA continues to focus on the timeliness of remittance of participant contributions in contributory employee benefit plans. Participant contributions are plan assets on the earliest date that they can reasonably be segregated from the employer's general assets, but in no event later than (1) for pension plans, the 15th business day of the month following the month in which the participant contributions are withheld or received by the employer, and (2) for welfare plans, 90 days from the date on which such amounts are withheld or received by the employer.

Reporting of Late Remittances

.204 Failure to remit or untimely remittance of participant contributions constitutes a prohibited transaction under ERISA Section 406, regardless of materiality. Such transactions constitute either a use of plan assets for the benefit of the employer or a prohibited extension of credit. In certain circumstances, such transactions may even be considered an embezzlement of plan assets.

.205 Information on all delinquent participant contributions should be reported on line 4a of either Schedule H or Schedule I of the Form 5500 regardless of the manner in which they have been corrected. In addition, plan administrators should correct the prohibited transaction with the IRS by filing a Form 5330 and paying any applicable excise taxes.

.206 The following apply to large plans that are subject to the audit requirement:

- Delinquent participant contributions reported on line 4a that constitute prohibited transactions (excluding those that have been corrected under the Voluntary Fiduciary Correction Program [VFCP] and for which the conditions of Prohibited Transaction Exemption [PTE] 2002-51 have been satisfied, as described subsequently) may be reported on a separate supplemental schedule to be attached to the Form 5500 and reported on by the IQPA.
- ERISA and DOL regulations require additional information to be disclosed in supplemental schedules. Some of this information is required to be covered by the auditor's report. SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA,

Professional Standards, AU sec. 551A),[13] as amended, provides guidance on the form and content of reporting when the auditor submits a document containing information accompanying the basic financial statements. If the auditor concludes that the plan has entered into a prohibited transaction, and the transaction has not been properly disclosed in the required supplemental schedule, the auditor should (1) express a qualified opinion or an adverse opinion on the supplemental schedule if the transaction is material to the financial statements or (2) modify his or her report on the supplemental schedule by adding a paragraph to disclose the omitted transaction if the transaction is not material to the financial statements. See chapter 11 of AICPA Audit and Accounting Guide *Employee Benefit Plans* for further discussion of prohibited transactions.

Reporting of Delinquent Loan Repayments

.207 Generally speaking, participant loan repayments are not subject to the DOL's participant contribution regulation (29 CFR 2510.3-102). Accordingly, its delinquent remittance is not reported on line 4a of either Schedule H or Schedule I. However, delinquent remittance of participant loan repayments is a prohibited transaction.

.208 In Advisory Opinion 2002-2A, the DOL concluded that, although not subject to the participant contribution regulation, participant loan repayments paid to or withheld by an employer for purposes of transmittal to an employee benefit plan are sufficiently similar to participant contributions to justify, in the absence of regulations providing otherwise, the application of principles similar to those underlying the final participant contribution regulation for purposes of determining when such repayments become assets of the plan. Specifically, the Advisory Opinion concluded that participant loan repayments paid to or withheld by an employer for purposes of transmittal to the plan become plan assets as of the earliest date on which such repayments can reasonably be segregated from the employer's general assets.

.209 Accordingly, the DOL will not reject a Form 5500 report based solely on the fact that delinquent forwarding of participant loan repayments is included on Line 4a of the Schedule H or Schedule I. Filers that choose to include such participant loan repayments on Line 4a must apply the same supplemental schedule and IQPA disclosure requirements to the loan repayments as apply to delinquent transmittals of participant contributions.

.210 Delinquent forwarding of participant loan repayments is eligible for correction under the VFCP and PTE 2002-51 on terms similar to those that apply to delinquent participant contributions.

.211 For questions or further information, contact the Office of Regulations and Interpretations at the DOL at (202) 693-8500 or visit www.dol.gov/ebsa.

2010 Form M-1 for Multiple Employer Welfare Arrangements

.212 On January 6, 2011, the DOL published in the Federal Register the 2009 Form M-1 annual report for multiple employer welfare arrangements (MEWAs). Plan administrators may use EBSA's online filing system to expedite processing of the form.

.213 MEWAs generally are arrangements that offer medical benefits to the employees of two or more employers or to their beneficiaries. The filing deadline for the 2010 Form M-1 is March 1, 2011. Administrators can request, however, an automatic 60-day extension until May 2, 2011. The 2010 form is basically identical to the previous year's form.

[13] In February 2010, the AICPA issued SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole,* (AICPA, *Professional Standards*, AU sec. 551), which, along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*. SAS No. 119 addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted. See the "Supplementary and Other Information Related to Financial Statements" section of this alert for further information.

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.214 The online filing system is available at www.askebsa.dol.gov/mewa. It allows filers the flexibility to complete the form in multiple sessions, print a copy for his or her records and submit it at no cost. The website includes a user manual, frequently asked questions and a link to submit questions electronically.

Help Desk: Filers can use the following information to receive assistance:

- For the online filing system, call (202) 693-8600
- For Form M-1, visit www.askebsa.dol.gov/mewa or call (202) 693-8360

DOL Proposed Rule to Enhance Target Date Retirement Fund Disclosures

.215 On November 30, 2010, the DOL published in the Federal Register a proposed rule that would amend the "qualified default investment alternative regulation" and the "participant-level disclosure regulation" to enhance and provide more specificity regarding the information that must be disclosed to participants and beneficiaries concerning investments in qualified default investment alternatives, including target date or similar investments.

.216 The proposal also contains an amendment to the participant-level disclosure regulation that would require the disclosure of the same information concerning target date or similar investments to all participants and beneficiaries in participant-directed individual account plans.

.217 The proposed amendments require new disclosures about the design and operation of target date or similar investments, including an explanation of

- the investment's asset allocation;
- how that allocation will change over time, with a graphic illustration;
- the significance of the investment's "target" date; and
- a statement that a participant investing in a target date fund (TDF) risks losing money in that investment, even close to retirement.

You can view the proposed regulation and a related fact sheet www.dol.gov/ebsa.

.218 In addition, on May 6, 2010, the DOL and the SEC announced guidance to help investors and plan participants better understand the operations and risks of TDF investments. The guidance is designed to assist investors and participants in assessing the benefits and risks associated with TDFs and the appropriateness of including such an investment as part of their retirement portfolios.

.219 The guidance describes some basics features of TDFs, including the investment mix of such funds, the risks associated with the investments, how TDFs operate, and ways to evaluate a target date retirement fund that will help increase awareness of both the value and risks associated with these types of investments.

Help Desk: "Investor Bulletin: Target Date Retirement Plans" is available at www.dol.gov/ebsa or at www.sec.gov.

DOL Proposed Rule to Implement Annual Funding Notice Requirement for Defined Benefit Pension Plans

.220 On November 18, 2010, the DOL, pursuant to a requirement imposed by the PPA, published in the Federal Register a proposed rule to implement the annual funding notice requirement under section 101(f) of ERISA.

.221 The proposed regulation requires administrators of all defined benefit plans that are subject to Title IV of ERISA to provide an annual funding notice to the PBGC, to each plan participant and beneficiary, to each

labor organization representing such participants or beneficiaries and, in the case of a multiemployer plan, to each employer that has an obligation to contribute to the plan. Prior to implementation of the PPA, only multiemployer plans were required to disclose any funding information.

.222 An estimated 29,500 plans covering approximately 44 million participants and beneficiaries are subject to these disclosure requirements. Among other information, a funding notice must include the plan's funding target attainment percentage or funded percentage, as applicable, over a period of time. You can view the proposed regulation, including model notices, at www.dol.gov/ebsa.

DOL Proposed Rule Defining Fiduciaries of Employee Benefit Plans

.223 On October 22, 2010, the DOL published in the Federal Register a proposed rule to update the definition of *fiduciary* to more broadly define the term as a person who provides investment advice to plans for a fee or other compensation.

.224 The proposed rule would amend a 1975 regulation that defines when a person providing investment advice becomes a fiduciary under ERISA. The proposed amendment would update that definition to take into account changes in the expectations of plan officials and participants who receive advice, as well as the practices of investment advice providers. You can view the proposed regulation at www.dol.gov/ebsa.

DOL Final Rule on Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans

.225 On October 20, 2010, the DOL published in the Federal Register a final rule that requires the disclosure of certain plan and investment-related information, including fee and expense information, to participants and beneficiaries in participant-directed individual account plans (for example, 401(k) plans).

.226 This rule will ensure that all workers who direct their plan investments have access to the information they need to make informed decisions regarding the investment of their retirement savings, including fee and expense information. Under the rule, workers will receive this information in a format that enables them to meaningfully compare the investment options under their plans.

.227 The final regulation requires plan fiduciaries to

- give workers quarterly statements of plan fees and expenses deducted from their accounts;
- give workers core information about investments available under their plan including the cost of these investments;
- use standard methodologies when calculating and disclosing expense and return information to achieve uniformity across the spectrum of investments that exist in plans;
- present the information in a format that makes it easier for workers to comparison shop among the plan's investment options; and
- give workers access to supplemental investment information in addition to the basic information required under the final rule.

> **Help Desk:** You can view the final rule, including a fact sheet and sample investment chart, at www.dol.gov/ebsa.

DOL Proposed Rule to Amend the Procedures for Filing and Processing Prohibited Transaction Exemptions

.228 On August 30, 2010, the DOL published in the Federal Register a proposed rule that would amend the procedures for filing and processing prohibited transaction exemptions under ERISA.

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.229 The proposal, if adopted, would consolidate the existing policies and guidance on the exemption process. The amended procedures would also clarify the types of information and documentation required to submit a complete filing, expand the methods for transmitting filings to include electronic submissions, and make the exemptions more understandable for participants and other interested parties.

.230 The proposed exemption procedure retains the section-by-section topical structure of the existing regulation. Among the proposed changes are

- a requirement that applicants provide interested persons with a brief objective summary of complex transactions;
- the consolidation of exemption policies and guidance within a single document;
- an updated description of the DOL's authority to propose and issue administrative exemptions on its own motion;
- a description of the current standards for obtaining retroactive exemption relief; and
- clarification of the content of specialized statements, as needed, from qualified independent appraisers and other relevant experts.

You can view the proposed rule at www.dol.gov/ebsa.

DOL Interim Final Rule on Disclosure of Fees and Conflicts of Interest Affecting 401(k) and Other Retirement Plans

.231 On July 16, 2010, the DOL issued in the Federal Register an interim final rule to enhance disclosure to fiduciaries of 401(k) and other retirement plans and assist fiduciaries in determining both the reasonableness of compensation paid to plan service providers and any conflicts of interest that may affect a service provider's performance under a service contract or arrangement.

.232 The rule requires that covered service providers satisfy certain disclosure requirements in order to qualify for the statutory exemption for services under ERISA section 408(b)(2). These requirements include the disclosure of the direct and indirect compensation certain service providers receive in connection with the services they provide. The rule applies to plan service providers that expect to receive $1,000 or more in compensation and that provide certain fiduciary or registered investment advisory services; make available plan investment options in connection with brokerage or recordkeeping services; or otherwise receive indirect compensation for providing certain services to the plan. The new disclosure rules are effective January 1, 2012, and the rules and the related fact sheet can be viewed at www.dol.gov/ebsa.

DOL Proposed Amendment to Class Exemption on Transactions Determined by In-House Asset Managers

.233 On June 14, 2010, the DOL published in the Federal Register a proposal to amend PTE 96-23. This proposed amendment would create a class exemption that would allow in-house managers of large employee benefit plans to engage in a wide range of transactions with related parties.

.234 The proposed amendment, if granted, would

- remove numerous administrative burdens that have been cited by practitioners, and would expand relief under the class exemption to include certain transactions not currently permitted;
- address practitioner uncertainty that exists regarding certain provisions contained in the class exemption; and
- clarify the DOL's views and expectations regarding the class exemption's annual audit and written report requirements. The application of these requirements will further enhance the participant protections embodied in the class exemption.

DOL Correspondence

No Processing-Related Correspondence Under EFAST2

.235 Under EFAST2, the DOL's all-electronic processing system for the Form 5500 and the new Form 5500-SF annual return/reports, filers will not receive written "edit test" correspondence regarding deficiencies identified during processing. Forms 5500 and 5500-SF are required to be prepared and submitted using DOL's IFILE application or EFAST2-approved third party software. Filers will be able to identify many of their own errors by using the "validate" feature in IFILE and helpful automatic error identifiers in EFAST2-approved third party software.

.236 In addition, those filings containing errors or omissions will continue to be subject to further review and possible civil penalties by the DOL, IRS, and PBGC. Plan auditors may consider communicating this processing change to their benefit plan clients and encourage them to take extra care when completing their Form 5500 filings.

Correspondence from the Office of the Chief Accountant

.237 The DOL's Office of the Chief Accountant (OCA) has the responsibility for enforcing ERISA reporting and disclosure requirements. This includes ensuring that the Form 5500 filings are filed timely and correctly, and determining whether plan audits are performed in accordance with professional auditing standards and regulatory requirements. The OCA routinely queries the ERISA database and targets for review Form 5500 filings that satisfy certain criteria, including those filings in which processing errors have gone uncorrected and those with improperly prepared auditor's reports. The OCA staff reviews the Form 5500 filings and also request copies of the independent auditor's working papers that support audit engagements. If the OCA staff identifies problems related to the Form 5500 or the audit working papers, a formal enforcement process commences with the issuance of a Notice of Rejection (NOR) against the plan administrator.

.238 Upon receipt of an NOR, the plan administrator has 45 days to make any necessary corrections to the Form 5500 filing. This may involve the auditors having to correct their audit reports or even perform additional fieldwork in audit areas where work was previously not performed or deemed by the DOL to be insufficient. At the end of the 45-day period, if the Form 5500 filing remains deficient, the DOL issues a Notice of Intent to Assess a Penalty (NOI), potentially subjecting the plan administrator to civil penalties of up to $1,100 per day (imposed from the day after the original due date of the filing). As a policy matter, however, most deficiencies are penalized at $150 per day with penalties capped at $50,000.

.239 When plan administrators receive an NOI, they have 35 days to submit to the DOL a Statement of Reasonable Cause, submitted under penalty of perjury, in which they set forth any reasons why the penalty should be abated in part or in full. (It is important to note that traditionally the DOL will not consider abatement of any penalties in cases where deficiencies still exist.) If the plan administrator fails to comply with the requirements of the NOI, the penalty becomes a final agency action, and the plan administrator forfeits all appeal rights.

.240 After the DOL reviews the statement of reasonable cause, the agency issues a Notice of Determination that contains the final penalty amount assessed against the plan administrator. The plan administrators may choose to pay the penalty amount or, within 35 days as provided for in the letter, file an "Answer" with the administrative law judge, appealing the penalty.

> **Help Desk:** Any questions regarding the DOL penalty process should be directed to the OCA at (202) 693-8360.

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EBSA's Inspection Programs to Assess Plan Audit Quality

.241 The DOL's EBSA continues its enhanced programs aimed at assessing and improving the quality of employee benefit plan audits. According to the EBSA, 64 public accounting firms audit more than 100 plans that cover approximately 25,000 audits. The remaining 51,000 plan audits are performed by nearly 10,000 different CPA firms, 8,000 of whom perform five or fewer audits. The EBSA utilizes both top-down and bottom-up strategies in selecting and evaluating ERISA audits.

.242 First, the EBSA conducts periodic inspections of firms with substantial ERISA audit practices—those with greater than 200 benefit plan clients. The EBSA staff meet with firm management, review firm policies and procedures that relate to employee benefit plan audits, and conduct on-site reviews of a sample of ERISA audit engagements. This "top-down" and "bottom-up" approach provides the EBSA a more efficient means of evaluating the quality of audit work performed by these large firms and ensuring that findings and recommendations are communicated to those in a position to effect any necessary changes. To date, the EBSA has completed 22 such reviews.

.243 Next, for firms that audit between 100 and 200 employee benefit plans, the EBSA carries out what it refers to as a "mini-inspection" program. This program is similar to the inspection program for larger firms, except that the work is performed in the EBSA's Washington, D.C. office. The top-level communications with firm management and personnel are conducted using a firm questionnaire (also used in the larger inspection program) and telephone interviews. A number of benefit plan engagements is also sampled, and firms are asked to make the audit working papers available for review in the EBSA's office.

.244 The "top-down" and "bottom-up" approach utilized in both the inspection and mini-inspection programs provides the EBSA an efficient means of evaluating the quality of audit work performed by these large firms and ensures that findings and recommendations are communicated to those in a position to effect any necessary changes. To date, the EBSA has completed inspections of 14 firms and mini-inspections of 15 firms.

.245 Finally, for firms with employee benefit plan audit practices of 50 or less plans, the EBSA focuses its in-house work on reviewing copies of audit working papers. To date, the EBSA has conducted over 2,200 of these desk reviews.

.246 In instances in which deficient audit work is identified, the related Form 5500 filings are subject to rejection, and auditors potentially face referral to the AICPA's Professional Ethics Division or State Board of Public Accountancy.

.247 The EBSA has also expanded its enforcement efforts dealing with fiduciary breaches to include determining whether plan auditors may be considered as "knowing participants." An auditor is considered a knowing participant if at least one of the three following elements is present:

- The plan auditor took affirmative action to further the violation.
- The plan auditor helped in concealing the violation.
- The plan auditor failed to act when required to do so by applicable professional standards.

Final Rule—Safe Harbor for Employee Contributions to Small Pension and Welfare Plans

.248 On January 14, 2010, the DOL published a final rule to protect employee contributions deposited to pension and welfare benefit plans with fewer than 100 participants by proposing a safe harbor period of seven business days following receipt or withholding by employers.

.249 The final rule amends the participant contribution rules to create a safe harbor period under which participant contributions to a small plan will be deemed to comply with the law if those amounts are deposited

with the plan within seven business days of receipt or withholding. Three examples are included in the final rule that illustrate its requirements.

.250 The DOL did not expand the safe harbor to cover plans with 100 or more participants due to a lack of information and data sufficient to evaluate current practices of such employers and assess the costs, benefits and risks to participants associated with extending the safe harbor to large plans. The final rule may be viewed at www.dol.gov/ebsa.

Revised Large Plan Example for Regulation on Timeliness of Deposits

.251 As noted in the previous section, the DOL issued the seven day safe harbor rule on the timeliness of the deposit of salary deferrals and loan payments for small plans. This safe harbor final rule includes illustrative examples which encompass the new requirements. These illustrations included a modification to the example for a large plan which received less attention. The conclusion in the large plan example was changed from

> "Therefore, the assets of X's 401(k) plan would include the participant contributions no later than 10 business days after the end of the month."

to now read

> "The assets of B's 401(k) plan would include the participant contributions no later than 3 business days after the issuance of paychecks." [Amended January 14, 2010 by 75 FR 2068].

.252 The new regulation became effective January 14, 2010. Plan sponsors and their service providers who previously relied on the example need to consider the changes made by this amendment. See the Electronic Code of Federal Regulations website at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=6c06682d754e8fb62a2bd2e731a233e2&rgn=div8&view=text&node=29:9.1.3.2.2.0.10.9&idno=29.

.253 Plan officials faced with remitting delinquent participant contributions should consider applying to the DOL's VFCP. Plans that fully comply with the program, including satisfaction of the conditions of PTE 2002-51 will

- receive a "no-action" letter issued by the DOL that provides for no imposition of section 502(l) penalties;
- receive relief from the excise tax provisions of the IRC;
- continue to report the occurrence and amount of the corrected delinquent remittances on line 4a of either Schedule H or Schedule I (but not on line 4d or Schedule G); and
- not be required to report such transactions as supplemental information if the plan is required to be audited because the transactions are not considered to be prohibited transactions.

.254 See the EBSA's website at www.dol.gov/ebsa, which contains useful information about the VFCP, including a fact sheet, a frequently asked questions (FAQs) section, and a sample "no-action" letter.

Delinquent Filer Voluntary Compliance Program

.255 The Delinquent Filer Voluntary Compliance Program (DFVCP) is designed to encourage voluntary compliance with the annual reporting requirements under ERISA. The program gives delinquent plan administrators a way to avoid potentially higher civil penalty assessments by satisfying the program's requirements and voluntarily paying a reduced penalty amount. To increase incentives for delinquent plan administrators to voluntarily comply, the department has reduced penalties and simplified the rules governing participation in the program.

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Address to be used for the DFVCP

.256 Please note: This is a new address and there is no longer an overnight delivery address.

Standard Mail
DFVC Program – DOL
P.O. Box 71361
Philadelphia, PA 19176-1361

DFVCP Penalty Calculator and Online Payment Option

.257 The DOL provides two Web-based options that make participating in the DFVCP easy, quick, and error-free. An online DFVCP penalty calculator is available to help plan administrators accurately calculate the payment needed to participate in the program. In addition, plan administrators who use the online calculator have the option of paying the penalty electronically over the Internet.

> **Help Desk:** Additional details on the online calculator and online payment option may be found in the DFVCP FAQs: www.dol.gov/ebsa/calculator/dfvcpmain.html.

Program Eligibility

.258 Eligibility in the DFVCP continues to be limited to plan administrators with filing obligations under Title I of ERISA who comply with the provisions of the program and who have not been notified in writing by the DOL of a failure to file a timely annual report under Title I of ERISA. Form 5500-EZ filers and Form 5500 filers for plans without employees (as described in 29 CFR 2510.3-3(b) and (c)) are not eligible to participate in the DFVCP because such plans are not subject to Title I.

Using the DFVCP in an Electronic Era

.259 Participation in the DFVCP continues to be a two-part process. First, plan administrators must file with the EBSA a complete Form 5500 Series annual return/report, including all schedules and attachments, for each year relief is requested.

> ***Note:*** All filings, regardless of the year must be submitted electronically through EFAST2 in an approved electronic format. For detailed information concerning which schedules should be filed with prior year filings, please visit the EFAST 2 FAQs website: www.dol.gov/ebsa/faqs/faq-EFAST2.html.

.260 Second, plan administrators must submit to the DFVCP the required documentation and applicable penalty amount. Plan administrators may choose to submit their DFVC filing and payment electronically using the Online Calculator (www.askebsa.dol.gov/dfvcepay/calculator) or file through the mail by submitting a paper copy the 5500 and a paper check.

.261 The plan administrator is personally liable for the applicable penalty amount, and, therefore, amounts paid under the DFVCP are not to be paid from the assets of an employee benefit plan.

.262 Special simplified rules apply to "top hat" plans and apprenticeship and training plans.

Penalty Structure

.263 The penalty structure under the DVFCP is as follows:

- *Per day penalty.* The basic penalty under the program is $10 per day for delinquent filings.
- *Per filing cap.* The maximum penalty for a single late annual report is $750 for a small plan (generally a plan with fewer than 100 participants at the beginning of the plan year) and $2,000 for a large plan.
- *Per plan cap.* This cap is designed to encourage reporting compliance by plan administrators who have failed to file an annual report for a plan for multiple years. The "per plan" cap limits the penalty to $1,500 for a small plan and $4,000 for a large plan regardless of the number of late annual reports filed for the plan at the same time. There is no "per administrator" or "per sponsor" cap. If the same party is the administrator or sponsor of several plans required to file annual reports under Title I of ERISA, the maximum applicable penalty amounts would apply for each plan.
- *Small plans sponsored by certain tax-exempt organizations.* A special "per plan" cap of $750 applies to a small plan sponsored by an organization that is tax-exempt under IRC section 501(c)(3). The $750 limitation applies regardless of the number of late annual reports filed for the plan at the same time. It is not available, however, if as of the date the plan files under the DFVCP there is a delinquent annual report for a plan year during which the plan was a large plan.
- *"Top hat" plans and apprenticeship and training plans.* The penalty amount for "top hat" plans and apprenticeship and training plans is $750.

IRS and PBGC Participation

.264 Although the DFVCP does not cover late filing penalties under the IRC or Title IV of ERISA, the IRS and PBGC agreed to provide certain penalty relief for delinquent Form 5500s filed for Title I plans where the conditions of the DFVCP have been satisfied.

Help Desk: Questions about the DFVCP should be directed to EBSA by calling (202) 693-8360. For additional information about the Form 5500 Series, visit the EFAST website at www.efast.dol.gov, or call the EBSA Help Desk toll-free at (866) 463-3278.

Voluntary Fiduciary Correction Program

.265 The VFCP encourages voluntary compliance by self-correcting violations of the law. The program also helps plan officials understand the law and gives immediate relief from payment of excise taxes under a class exemption.

.266 In April 2006, the EBSA expanded and simplified the VFCP to help employers and their professional advisors voluntarily correct violations of the law for employee benefit plans. This update to the VFCP reflects public comments and includes

- expansion and simplification of eligible transactions;
- streamlined documentation and clarified eligibility requirements;
- a model application form;
- clarification of what constitutes "under investigation" allowing more entities to qualify for the program, and
- relief from civil penalties for transactions involving health and welfare plans.

.267 Under the VFCP, employers may voluntarily correct specific ERISA violations. Applicants must fully correct any violations, restore to the plan any losses or profits with interest, and distribute any supplemental

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benefits owed to eligible participants and beneficiaries. A "no action" letter is given to plan officials who properly correct violations.

.268 The DOL also provides applicants conditional relief from payment of excise taxes for certain VFCP transactions under a class exemption related to the VFCP. The amended class exemption was also published in the Federal Register in April 2006.

> **Help Desk**: More information about the VFCP is available by contacting a local EBSA regional office through its toll-free number, (866) 444-EBSA (3272), or by visiting the website at www.dol.gov/ebsa under "Correction Programs."

DOL Outreach and Customer Service Efforts

.269 The DOL's EBSA continues to encourage auditors and plan filers to call its Division of Accounting Services at (202) 693-8360 with ERISA-related accounting and auditing questions. Questions concerning the filing requirements and preparation of Form 5500 should be directed to the EBSA's EFAST Help Desk at its toll-free number, (866) 463-3278.

.270 In addition to handling technical telephone inquiries, the EBSA is involved in numerous outreach efforts designed to provide information to practitioners to help their clients comply with ERISA's reporting and disclosure requirements. The agency's outreach efforts continue to focus on plan audit quality, the current Form 5500 and Form 5500-SF, the EFAST2 Processing System, and other agency-related developments. Questions regarding these outreach efforts should be directed to the OCA at (202) 693-8360.

> **Help Desk:** Practitioners and other members of the public may also want to contact the EBSA at www.dol.gov/ebsa. The website also provides information on EBSA's organizational structure, current regulatory activities, and customer service and public outreach efforts.

Field Assistance Bulletins

.271 In the course of audits and investigations by EBSA field enforcement staff, difficult legal issues often arise. In an effort to provide the regional office staff with prompt guidance, EBSA has developed a vehicle for communicating technical guidance from the national office. FABs ensure that the law is applied consistently across the various regions. They also provide the regulated community with an important source of information about the EBSA's views on technical applications of ERISA.

.272 Currently, 24 FABs are outstanding. They cover many topics of current interest such as refinancing ESOP loans (FAB 2002-1), ERISA rules on participant loans where securities law might otherwise limit such loans (FAB 2003-1), duties to lost participants in a terminated plan (FAB 2004-2), interaction between IRS rules and DOL provisions for 403(b) plans (FAB 2007-2), the responsibilities for ERISA fiduciaries to collect delinquent contributions (FAB 2008-1), and Form 5500 filing by 403(b) plans (FAB 2009-02).

> **Help Desk**: The FABs are available at www.dol.gov/ebsa under "Field Assistance Bulletins."

IRS and Treasury Department Developments

.273 The following section summarizes some of the more important developments within the IRS and Treasury Departments.

Plan Amendments

.274 The following list includes plan amendments that may have been required for the 2010 plan year. For a complete listing, see the IRS 2010 cumulative list (IRC Notice 2010-90) at www.irs.gov/pub/irs-drop/n-10-90.pdf.

- Amendments to comply with certain provisions of the PPA relating to stock diversification requirements, benefit restrictions, and hybrid plans require adoption by the last day of the first plan year beginning on or after January 1, 2010
- Amendments relating to the Heroes Earnings and Assistance Relief Tax Act of 2008 require adoption by the end of 2010 for calendar-year plans
- Certain provisions relating to automatic contribution arrangements require adoption by the *later of* the last day of the 2010 plan year or the due date of the employer's tax return that includes the first day of the 2010 plan year
- The plan amendments for a defined benefit plan which formalize the requirement that certain distribution forms must be modified based upon the plans funded status are due by the last day of the first plan year beginning on or after January 1, 2010 (See IRS Notice 2009-97)

.275 In addition to the preceding items, it is important to remember that any elective changes (for example, benefit terms, eligibility, or allocation rates) must be adopted no later than the last day of the plan year.

Defined Benefit Plan Funding Relief

.276 The Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010 (PRA 2010) provided funding relief by allowing a plan sponsor to elect to extend the shortfall amortization period. IRS Notice 2011-3 provides guidance on how a sponsor elects one of the two alternative funding schedules allowed by PRA 2010 for one or two of the eligible plan years (2009, 2010, and 2011). A sponsor of a calendar year plan must have made the election by January 31, 2011, for plan years 2009 or 2010. For the 2011 plan year, the sponsor has until December 31, 2011, to elect. IRS Notice 2010-83 describes the procedures for multiemployer plans.

In-Plan Roth Rollovers

.277 IRS Notice 2010-84 describes the procedures and reporting for a plan which permits an in-plan Roth rollover. This is the conversion of a pretax account into an after-tax or Roth account. This conversion does involve the reporting of a distribution. Therefore, the auditor needs to recognize that the reported distributions may not correlate to amounts that were actually distributed from the plan. This privilege to convert is effective September 27, 2010. The plan does not have to be amended to incorporate these terms until the *later of* the last day of the plan year in which the privilege to convert became effective or December 31, 2011.

COBRA Subsidy

.278 The COBRA (Consolidated Omnibus Reconciliation Act) subsidy was extended on April 15, 2010, for those individuals who were involuntarily terminated, through May 31, 2010. Those individuals will be eligible for the full 15 months of coverage at the subsidized rate. The prior subsidy expired on March 31, 2010. Those individuals who lost employment between April 1, 2010, and April 14, 2010, were granted the subsidy.

Section 403(b) Plan Terminations

.279 In February 2011, the IRS published Revenue Ruling 2011-7 (Rev. Rul. 2011-7), which provides guidance on the plan termination rules under Reg. Sec. 1.403(b)-10(a). According to Rev. Rul. 2011-7, in order for a 403(b) plan to be considered terminated, all accumulated benefits under the plan must be distributed to all participants and beneficiaries as soon as administratively practicable after termination of the plan. Rev. Rul. 2011-7 provides several examples that satisfy the distribution requirements. In addition, the tax treatment of

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distributions to plan participants or their beneficiaries is discussed. See www.irs.gov/pub/irs-drop/rr-11-07.pdf for additional information regarding 403(b) plan terminations.

Replacement of Schedule SSA with Form 8955-SSA

.280 In accordance with IRS Announcement 2011-21, the IRS coordinated with the Social Security Administration, and developed Form 8955-SSA, *Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits,* a stand-alone form to be filed with the IRS. Form 8955-SSA replaced the Schedule SSA (Form 5500). For plan years beginning on or after January 1, 2009, the Form 8955-SSA should be used to comply with the reporting requirements of IRC section 6057(a). Form 8955-SSA for the 2009 plan year is expected to be available for plan administrators early in 2011, with the 2010 form available for filing later in the year. See www.irs.gov/pub/irs-drop/a-11-21.pdf for additional information regarding Form 8955-SSA.

Foreign Bank Account Filings

.281 Over the last two years, the IRS has been working to clarify if and when benefit plan fiduciaries may be required to file a Report of Foreign Bank and Financial Accounts, IRS Form TD F 90-22.1 (FBAR). See IRS Notice 2010-23 for the current status of the relief granted in this area. It is important to recognize that this notice does not specifically address benefit plans; it merely describes relief in the context of the nature of the plan's interest in a foreign financial account.

.282 The basic filing duties with respect to employee benefit plans are as follows:

- Plan filers invested in a foreign account, such as a foreign mutual fund, must file an FBAR. The 2009 filing was due by June 30, 2010. The 2010 filing will be due by June 30, 2011. Note that the plan is not required to file for a domestic mutual fund with foreign investments, only a foreign mutual fund.
- Plan filers with only signature authority over a foreign financial account (that is, no financial interest in such account) have received a one-year extension of their filing deadline through June 30, 2011.
- Plan filers with either a financial interest in, or signature or other authority over, a foreign comingled account other than a foreign mutual fund are not required to file an FBAR for 2009 and prior years but may be required for the 2010 year. This is one of the many unresolved issues in this area.

.283 Significant penalties can be imposed on a filer, thus benefit plans holding foreign accounts should follow these developments. See the FAQs related to an FBAR at www.irs.gov/businesses/small/article/0,,id=148845,00.html.

EBP Guide Overhaul Status

.284 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Employee Benefit Plans*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1991. A working draft of the accounting related guidance is expected to be posted to the AICPA website in the second quarter of 2011. The purpose of the working draft is to solicit comments from preparers, auditors, and users of employee benefit plan financial statements and other interested parties. Be alert for the posting of this working draft.

Recent AICPA Independence and Ethics Developments

.285 Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

On the Horizon

.286 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance for employee benefit plans or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.287 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.288 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board (IAASB). The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the second half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU sections 341, *The Auditor's Consideration of the Entity's Ability to Continue as a Going Concern*, and 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*).

.289 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.290 The year 2010 was a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the International Accounting Standards Board (IASB) have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and

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cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects.

.291 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of International Financial Reporting Standards (IFRSs) as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Financial Instruments Exposure Draft

.292 In January 2011, the IASB and FASB published a proposal for accounting for impairment of financial assets managed in an open portfolio. For U.S. GAAP, this proposal applies to open portfolios of loans and debt instruments that are not measured at fair value with changes in value recognized in net income. This proposal is a supplement to the exposure draft published by the IASB in November 2009 and the FASB exposure draft published in May 2010. The new proposal is the product of an aligned approach between the boards regarding how to account for credit impairment and takes into consideration feedback received on the aforementioned exposure drafts and recommendations by the Expert Advisory Panel.

.293 FASB expects to issue final guidance that includes credit impairment during 2011.

.294 FASB has issued FAQs for the proposed ASU to clarify the proposal by answering common questions received about the proposed guidance. You can access this document at www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157295447 (note this FAQ has not been updated for the January 2011 impairment supplementary document). You can find the exposure draft in its entirety, the impairment supplementary document, and project updates at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011123.

Fair Value Exposure Draft

.295 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.296 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and

disclosure requirements in U.S. GAAP and IFRSs. A final ASU is expected to be issued in the first quarter of 2011. You can find updates on this project at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156576143.

FASB Accounting Pipeline

Other Accounting Projects

.297 Additionally, FASB has the following projects underway:

- Disclosure of certain loss contingencies
- Risks and uncertainties
- Insurance contracts
- Investment properties
- Disclosure framework

Employee Benefit Plan Resources

.298 The following are various resources that practitioners engaged in the employee benefit plan industry may find beneficial.

AICPA Employee Benefit Plan Audit Quality Center

.299 The AICPA EBPAQC is a firm-based, voluntary membership center of over 2,080 firms with the goal of promoting quality employee benefit plan audits. EBPAQC member firms receive valuable ERISA audit and firm best practice tools and resources that are not available from any other source.

.300 The EBPAQC provides timely e-alerts with information about recent developments affecting employee benefit plan audits, as well as other resources and tools including

- Audit and Accounting Resource Centers, including limited scope audits, 403(b) plans, SAS No. 115 communications for benefit plans, plan investments, EBP fraud, auditor independence and more.
- Exclusive member-only live forum webinars on current topics and preparing your firm for the EBP audit season. These webinars are free to members and continuing professional education (CPE) is available for paid registration.
- Center tools including a SAS No. 70 checklist[14] , internal self-inspection tool, illustrative FASB ASC 820 disclosures; a summary of DOL criminal enforcement cases; SAS No. 115, tools and examples of internal control communications for employee benefit plans.
- A Member-to-Member Online Discussion Forum with over 3,000 participants and 1,900 topics.
- "Topix" primer on topics such as plan investments in bank collective investment funds, limited scope audits, and 403(b) plans.

[14] For information regarding updates to SAS No. 70 reports see the "Service Organizations" section in this alert.

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- Plan Advisories to share with plan clients that help plan sponsors and administrators understand auditor communications and responsibilities of internal controls, monitoring outsourced services and plan investment valuation.

> **Help Desk:** Visit the center website at www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Pages/EBPAQhomepage.aspx to see a list of EBPAQC member firms and to preview EBPAQC benefits. For more information, contact the EBPAQC at ebpaqc@aicpa.org.

Publications

.301 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *Employee Benefit Plans* (2011) (product no. 0125911 [paperback], WEBXX12 [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- *Checklists and Illustrative Financial Statements for Defined Benefit Pension Plans* (2010) (product no. 0089910 [paperback] or WDB-CL [online])
- *Checklists and Illustrative Financial Statements for Defined Contribution Pension Plans* (2010) (product no. 0090010 [paperback] or WDC-CL [online])
- *Checklists and Illustrative Financial Statements for Health and Welfare Benefit Plans* (2010) (product no. 0090110 [paperback] or WHW-CL [online])
- *Accounting Trends & Techniques, 64th Edition* (product no. 0099010 [paperback] or WAT-XX [online])
- *Employee Benefit Plans Accounting Trends & Techniques, 3rd edition* (product no. 0066510 [paperback] or WET-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Audit and Accounting Practice Aid *SAS No. 70 Reports and Employee Benefit Plans* (product no. 061061 [paperback])
- Financial Reporting Alert *Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

AICPA Online Professional Library: Accounting and Auditing Literature

.302 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards*

Codification™, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]).To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com/library.

Continuing Professional Education

.303 The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry. Among the many courses, the following are specifically related to employee benefit plans:

- Audits of 403(b) Plans: A Challenging New Audit Area
- Audits of 401(k) Plans
- Employee Benefit Plans: Audit and Accounting Essentials

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.304 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com.

Webcasts

.305 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.306 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.307 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a technical inquiry form found on the same website.

Ethics Hotline

.308 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

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Industry Conference

.309 The AICPA offers an annual Employee Benefit Plans Accounting, Auditing, and Regulatory Update Conference in late fall. This conference is a two-day high-level forum that lets you interact with expert auditors and members of the DOL. The 2011 conference will be held December 12–13, 2011, in Washington, D.C.

.310 The AICPA offers an annual National Conference on Employee Benefit Plans each spring. The conference is a three-day conference designed to update attendees on recent developments related to employee benefit plans. The 2012 conference will be held in May 2012. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

AICPA Industry Expert Panel—Employee Benefit Plans

.311 For information about the activities of the Employee Benefit Plans Industry Expert Panel, visit the panel's Web page at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/EMPLOYEEBENEFITPLAN/Pages/EmployeeBenefitPlan.aspx.

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Appendix A—Definitions of Certain Investments

The following list includes certain investments as defined by the instructions to the Form 5500, Annual Return/Report of Employee Benefit Plan.

103-12 Entity. An entity that is not a master trust, common or collective trust, or pooled separate account whose underlying assets include plan assets within the meaning of Title 29 U.S. *Code of Federal Regulations* Part 2510.3-101 of two or more plans that are not members of a related group of employee benefit plans.

common or collective trust (CCT). A trust maintained by a bank, trust company, or similar institution that is regulated, supervised, and subject to periodic examination by a state or federal agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or a controlled group of corporations.

master trust. A trust for which a regulated financial institution (bank, trust company, or similar financial institution that is regulated, supervised, and subject to periodic examination by a state or federal agency) serves as trustee or custodian and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held.

pooled separate account (PSA). An account maintained by an insurance carrier, which is regulated, supervised, and subject to periodic examination by a state agency for the collective investment and reinvestment of assets contributed thereto from employee benefit plans maintained by more than one employer or a controlled group of corporations.

registered investment company. An investment firm that is registered with the Securities and Exchange Commission and complies with certain stated legal requirements for the collective investment and reinvestment of assets contributed thereto from investors (employee benefit plans and nonemployee benefit plans).

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Appendix B—Resources for Economic Information

The Internet covers a vast amount of information that may be valuable to auditors of employee benefit plans, including current industry trends and developments. Some of the more relevant sites not previously mentioned in this alert include those shown in the following table:

Organization	*Website*
Chartered Accountants of Canada Canadian Performance Reporting Alert MD&A Disclosures in Volatile and Uncertain Times	www.cica.ca/download.cfm?ci_id=47101&la_id=1&re_id=0
Emergency Economic Stabilization Act	www.treas.gov/initiatives/financial-stability/
Interagency Statement on the Regulatory Capital Impact of Losses on Fannie Mae and Freddie Mac Preferred Stock	http://files.ots.treas.gov/481135.pdf
Public Company Accounting Oversight Board (PCAOB) Staff Audit Practice Alert No. 3, *Audit Considerations in the Current Economic Environment* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.03)	www.pcaobus.org/Standards/QandA/12-05-2008_APA_3.pdf
PCAOB Standing Advisory Group Meeting Emerging Issue-Audit Considerations in the Current Economic Environment	www.pcaobus.org/News/Events/Documents/10222008_SAGMeeting/BP_Audit_Considerations.pdf

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Appendix C—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org

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Website Name	*Content*	*Website*
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov

[*The next page is 8179.*]

AAM Section 8070

State and Local Governmental Developments—2011

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *State and Local GovernmentalDevelopments—2010*.

This Audit Risk Alert is intended to provide auditors of financial statements of state and local governments with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully appreciates the invaluable assistance Christopher Cole provided in creating this publication.

The AICPA staff is grateful to the following individuals for their essential contributions in creating this publication:

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your state and local governmental audits and also can be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant

risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert.

.02 Further, if your state or local government audit is performed under *Government Auditing Standards* issued by the Comptroller General of the United States of America (also referred to as the Yellow Book or generally accepted government auditing standards) or Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations* (referred to as a single audit), you should refer to the AICPA Audit Risk Alert Government Auditing Standards *and Circular A-133 Audits—2011* (product no. 0224511). This alert can be obtained by calling the AICPA at 888.777.7077 or visiting www.cpa2biz.com.

Economic and Industry Developments

The Current Economy

.03 When planning and performing audit engagements, an auditor should understand both the general economic conditions and the specific economic conditions facing state and local governments. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

Key General Economic Indicators

.04 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.05 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.8 percent in the first quarter of 2011 (advance estimate), down slightly from 3.1 percent in the fourth quarter of 2010, and at an annual rate of 2.9 percent during calendar year 2010. From September 2009 to September 2010, the unemployment rate fluctuated between 9.5 percent and 10.1 percent. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.6 percent in 2010. An unemployment rate of 10 percent represents approximately 15.3 million people. Additionally, one reason for the continued high unemployment rate is that more Americans are resuming their search for work.

.06 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points, prior to the financial crisis, to less than 0.25 percent, where it remained through March 2011. The Federal Reserve described the current economic recovery in its March 15, 2011, press release as follows:

- The economic recovery is on a firmer footing.
- Overall conditions in the labor market appear to be improving gradually.
- Household spending and business investment in equipment and software continue to expand.
- Investment in nonresidential structures is still weak, and the housing sector continues to be depressed.
- Commodity prices have risen significantly since the summer, and concerns about global supplies of crude oil have contributed to a sharp run-up in oil prices in recent weeks.

.07 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant its holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term

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Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the beginning of the financial market turmoil in August 2007, total assets on the Federal Reserve's balance sheet have grown from $869 billion to $2.7 trillion, primarily as the result of the purchase of Treasury and mortgage-backed securities. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

The State of the States' Economy

.08 The Nelson A. Rockefeller Institute of Government (institute) publishes frequent updates on state fiscal conditions. The institute's *State Revenue Report*, dated February 2011, focuses on trends related to tax revenues and collections, including the following:

- State tax revenues for the third quarter of 2010 increased by 4.5 percent, which represents the third consecutive quarter of increased collections. Despite the increases in 2010, state tax revenues are still 7.5 percent lower than in the third quarter of 2008.
- Personal income and sales tax revenues each showed a 4.3 percent increase over the first three quarters of 2010. Sales tax revenue was 6.1 percent lower than in the third quarter of 2008.
- Local tax revenue increased by 5.9 percent in the third quarter of 2010, primarily as a result of increases in property and sales tax collections.

.09 The report concludes by pointing out that even though the overall economy has improved, tax revenue is still expected to be below prerecessionary levels in the near future. The full text of this report can be found at www.rockinst.org.

Challenges in the Municipal Securities Market

.10 In 2010, nearly $500 billion of municipal bonds and notes were sold to support a variety of public purposes. Additionally, more than 10.4 million municipal trades occurred, representing over $3.8 trillion in transactions during 2010. With approximately $2.9 trillion in principal value of securities outstanding and more than 50,000 issuers, the municipal market continues to play a vital role in the U.S. economy. However, due to current conditions, governments that rely heavily on public debt to finance their operations and current obligations may find that they will be paying more in interest and for shorter terms than expected to be able to draw the buyers they need. This could have a negative effect on the future cash flows of the government and its ability to meet its obligations.

.11 In recent years, the municipal market experienced several dislocations related to the subprime mortgage crisis and associated turmoil in the credit markets. These included the downgrading of municipal bond insurers and the collapse of the municipal auction rate securities (ARS) market.

.12 In 2011, the municipal bond market has still not recovered from the sell-off by investors and mutual funds that resulted, in part, from concerns about government bankruptcies and defaults. The recent press coverage about the extent of unfunded pension obligations of many state and local governments also contributes to the concern about the security of public debt. Uncertainty about the safety of municipal bonds, coupled with fears about changing tax rates, higher inflation, and low returns in relation to the perceived risk, have caused investors to sit on the sidelines until they have a better idea of the future.

.13 With demand down, governments, particularly those with lower than triple-A ratings, are not issuing new debt as frequently as they were previously nor are the dealers cutting prices to raise yields and draw buyers. Meanwhile, the 2010 election brought in a wave of fiscal conservatives at the state level who are pushing for a decrease in the reliance on debt as a means to fund government services and obligations. Furthermore, tighter budgets at the local levels due to declining revenue sources have resulted in delays and cancellations of capital projects and the borrowing activity that accompanies them. As a result, there has been an increase in bond auctions that end with some unsold balances. Failed auctions typically cause the ARS to default to the maximum rate defined in the related agreement. This adds significant interest rate volatility and may result in higher overall interest costs associated with the debt.

.14 Auditors should be aware of accounting and auditing issues that may result from debt instruments, such as the following:

- Bond restructurings, such as reacquisition, refinancing, or changing the interest rate mode (Governmental Accounting Standards Board [GASB] Statement No. 7, *Advance Refundings Resulting in Defeasance of Debt*, and GASB Statement No. 23, *Accounting and Financial Reporting for Refundings of Debt Reported by Proprietary Activities*)
- Derivative and hedge accounting implications, such as the effectiveness of interest rate swaps, the need to post collateral, or involuntary termination (GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*)
- Potential violation of debt covenants that may result in classification of the liability as current (GASB Statement No. 38, *Certain Financial Statement Note Disclosures*)
- Subsequent event disclosures for events such as extinguishment or modification of an ARS arrangement, failed auctions, or potential or actual cancellation of a liquidity facility (GASB Statement No. 56, *Codification of Accounting and Financial Reporting Guidance Contained in the AICPA Statements on Auditing Standards*, and AU section 560, *Subsequent Events* [AICPA, *Professional Standards*])
- Going concern issues (See the related discussion of the consideration of an entity's ability to continue as a going concern in the "Audit and Attestation Issues and Developments" section of this alert.)

.15 See also the related discussion on Municipal Securities Rulemaking Board (MSRB) activities in the "Legislative and Regulatory Developments" section of this alert.

The Availability and Quality of Credit and the Potential Impact on State and Local Governments

.16 Despite recent improvements in the economy, state and local governments are still struggling with enormous budget gaps that could further impair their ability to borrow. According to two reports issued by Moody's Investors Service (Moody's), credit ratings downgrades have outpaced upgrades for eight straight quarters as a result of decreased revenues. However, these downgrades do not necessarily indicate an increase in defaults on debts because revenue shortfalls are more likely to cause reductions in spending in areas other than debt payments. At the state level, these spending cuts are likely to take the form of reductions in aid to local governments, which include cities, counties, and school districts. This trend is the indicator that leads Moody's to conclude that the municipalities most at risk are smaller, weaker local governments and governments that have enterprises associated with them, such as municipal golf courses and nursing homes, because these entities are affected by the weak economy in the form of reduced revenues from both the state and enterprise funds. Both of these categories of governments are the most likely to be affected by decreases in funding from the state or county, as well as declines in collections from sales taxes and user fees. Auditors should consider whether a risk exists that the government's credit rating could be lowered due to these economic pressures. An auditor's understanding of the effects that a reduced credit rating would have on the government's ability to fund its operations or an understanding of whether a reduced rating would affect the government's outstanding debt obligations is an important element in assessing risk and designing audit procedures.

Governments That Enhance Their Financial Position Using Nonconventional Means

.17 Given the tightening of the credit markets, governments may look to enhance their financial positions through nonconventional means, such as service concession arrangements (SCAs), privatization, and business and activity combinations. For example, multiple cities may maintain their own library function, as may the county, and the various governments may find economic relief by combining operations. Such methods are viable but may be unusual and could present new accounting and internal control issues, so auditors would want to have an understanding of such arrangements.

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Local Government Bankruptcies

.18 Given the significant budget shortfalls that many municipalities are facing in the current economic environment, local governments in serious distress may consider filing for bankruptcy protection under Chapter 9 of *Bankruptcy*, *U.S. Code* (USC) 11, Section 901.

.19 The purpose of Chapter 9 is to provide a financially distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts. Reorganization of the debts of a municipality typically is accomplished by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan. Although similar to other chapters, in some respects, Chapter 9 is significantly different in that no provision exists in the law for liquidation of the assets of the municipality and distribution of the proceeds to creditors.

.20 Only a municipality may file for relief under Chapter 9. The term *municipality* is defined in 11 USC 101 as a "political subdivision or public agency or instrumentality of a State." The definition is broad enough to include cities, counties, townships, school districts, and public improvement districts. It also includes revenue-producing bodies that provide services that are paid for by users rather than by general taxes, such as bridge authorities, highway authorities, and gas authorities. States are not eligible to file under Chapter 9. Also, some states restrict or prohibit bankruptcy filings by municipalities.

.21 Municipal bankruptcy filings are a rare occurrence when compared with other types of bankruptcies. Of more than 55,000 municipal entities, less than 600 have filed under Chapter 9 since 1937, which is a very small number over many years when compared with the thousands of business filings under Chapters 7 and 11 that occur each year. Although rare, each municipal filing is significant to the government, its employees, its bondholders, and other stakeholders.

.22 Guidance can be found in GASB Statement No. 58, *Accounting and Financial Reporting for Chapter 9 Bankruptcies*, for governments that have filed for bankruptcy under Chapter 9, and GASB Statement No. 56, which addresses going concern considerations and requirements for governments. It is important to note that going concern considerations extend beyond governments that file for bankruptcy. See the related discussion of the consideration of an entity's ability to continue as a going concern in the "Audit and Attestation Issues and Developments" section of this alert.

Pensions and Other Postemployment Benefits

.23 In recent years, the focus on pensions and other postemployment benefits (OPEB), including retiree health benefits for state and local government employees, has been increasing. There have been several reasons for the additional attention to this area. First, because of the implementation of GASB Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*, and No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pensions*, several years ago, governments now measure and disclose in their financial statements their obligations to pay OPEB costs in a manner similar to that of GASB's current pension standards (that is, GASB Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and No. 27, *Accounting for Pensions by State and Local Government Employers*). Second, after the issuance of GASB Statement Nos. 43 and 45, GASB began a project to look at revising GASB Statement Nos. 23 and 25. Several due process documents have been issued to date, and an exposure draft is expected by mid-2011. Under current pension rules, neither the total obligation for pensions nor the unfunded portion is reported as a liability in a government's financial statements. Rather, a liability is reported if a government contributes less than the annual required contribution (ARC) calculated by an actuary. This is sometimes referred to as a pay as you go approach. GASB appears to be heading in the direction of proposing that the portion of the government's pension obligation that is not covered by assets in the pension plan (the unfunded obligation) be reported as a liability of the government on the face of the balance sheet. This would be a change that would likely result in a significant increase in unfunded liabilities during an already challenging economic environment.

.24 As a result of these factors, the media, the bond market, state and local government legislative bodies, and Congress are aware of the potentially significant sum of those obligations, sometimes in the billions of dollars for an individual state and often tens or hundreds of millions of dollars for individual local governments. In addition, a government that does not manage its liabilities on a go-forward basis, especially the growth in its liability, could find itself explaining its pension and OPEB funding policies or lack of a funding policy to credit rating agencies when issuing bonded debt.

.25 The underfunded status of state pension and OPEB plans was further highlighted in an April 2011 report by the Pew Center on the States that estimates that a $1.26 trillion gap existed at the end of fiscal year 2009, a 26 percent increase in 1 year. Pension funding shortfalls accounted for $660 billion, and unfunded retiree health care costs accounted for the remaining $635 billion. The figures detailed in the Pew report *The Widening Gap: The Great Recession's Impact on State Pension and Retiree Health Care Costs* include pension, health care, and other nonpension benefits promoted to both current and future retirees in states' and participate localities' public sector retirement systems. The full report is available at www.pewcenteronthestates.org.

.26 Many predict significant changes in pensions and OPEB as governing bodies become better informed through actuarial or similar valuations about the amount of the obligations and the effects of not managing them. Some governments have formed task forces to help them identify solutions. Common solutions that have been discussed for managing the pension and OPEB obligations and their growth include restricting new entrants into the plan, raising the employee cost share, lengthening the vesting period, restricting ad hoc benefit increases, and converting a defined benefit plan to a defined contribution plan. Another common solution is to begin to advance-fund the obligation, which is a long-term solution that will take years, with a well-managed funding program to fully fund the accrued liability. Some governments may even consider discontinuing or reducing benefits for current and retired employees, although that may not be possible because of legal, contractual, or other restraints. Whichever solutions are chosen by the entity, they likely will be difficult to implement.

.27 Because this is a topic that many governments are struggling with, auditors might consider staying abreast of GASB's current pension project and being prepared to answer their auditees' and governing bodies' questions about these obligations and about how potential future changes are to be accounted for.

Audit Considerations for Pensions and OPEB

.28 Even though GASB's pension project is still in the exposure stage, auditors should be cognizant of the risks when auditing pensions and OPEB under today's standards. The significant risks involved in accounting for pensions and OPEB stem primarily from the determination of the liability of underfunded plans. A small change in the estimates or methods used to calculate the ARC and accumulated benefit obligation can have a material effect on the financial statements of the governmental entity. The auditor might find it necessary to work with the actuarial firms retained by the auditee or, if necessary, retain actuarial specialists to evaluate auditee valuations. Some of the areas worthy of attention are as follows:

- Understanding the mechanics of the plan(s)
- Use of discount rates that are commensurate with actual funding patterns and reasonable, considering the investment return on the assets used to make contributions to the plan
- The accuracy and completeness of the data provided to the actuary by the auditee
- Understanding whether the actuarial methods and assumption used are allowable in relation to applicable accounting standards and consistently applied
- Determining whether assumptions are reasonable given the demographics of the covered persons in the plan
- Understanding the purpose and extent of changes in actuarial assumptions used to calculate ARC, especially when such changes reduce ARC or the actuarially determined liability
- The ability of the government to fund the plan in the future and how the funding will affect liquidity

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- The appropriateness of related note disclosures and management's discussion and analysis (MD&A)
- Whether the funding status of the plan merits an emphasis-of-matter paragraph in the auditor's report or a communication to those charged with governance

.29 For more information on the auditor's use of specialists, see the "Audit and Attestation Issues and Developments" section of this alert.

Legislative and Regulatory Developments

Securities and Exchange Commission Municipal Securities Activities

.30 On July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law. Of particular interest to auditors of state and local governments that issue municipal securities, the Dodd-Frank Act addressed a change in the registration requirements for investment advisors, including municipal advisors.

.31 The law defined municipal advisors to include, among other things, financial advisors. In September 2010, the Securities and Exchange Commission (SEC) followed up with Rule 15Ba2-6T, an interim final temporary rule that announced the procedure for the interim registration process in light of the October 1, 2010, effective date of the law. They received several comment letters on that interim rule that identified a lack of clarity about how the definition of *municipal advisor* would apply to accountants. The concerns that were raised related to the various services that CPA firms provide for governmental entities (for example, financial statement audits, consent letters, comfort letters, and so on) and whether the performance of those services would subject the firms to this registration process with the SEC.

.32 More recently, the SEC issued proposed Rules 15Ba1-1–15Ba1-7 in December 2010. In the proposed rules, the SEC did not carve accountants out completely because it stated that some of the services that may be provided would constitute advice that should require them to register, such as advice about the structure, timing, terms, and other similar matters concerning the issuance of municipal securities. Instead, the SEC acknowledged that some of the services CPA firms perform, such as the preparation or audit of financial statements or the issuance of letters for underwriters by accountants, would not constitute the provision of advice; hence, they would not have to register if performing only these services. The AICPA's comment letter on these proposed rules raised concerns that the definition of *municipal advisor* was very broad and will encompass accountants who are performing customary and usual services incidental to or inextricably linked to the practice of accountancy. It concluded that such customary and usual services should not be subject to the required registration. As of the date of this alert, the SEC has not issued a final regulation resolving the applicability of the registration requirement to accountants. Therefore, auditors with clients that issue municipal securities should follow this project and any clarifications ultimately made by the SEC with regard to the *municipal advisors* definition. For more information on the proposed rule or to read the AICPA's comment letter to the SEC, please visit www.aicpa.org/Advocacy/Issues/Pages/MunicipalAdvisors.aspx.

.33 Separately, the SEC has held several public hearings on the municipal securities market during the past year that examined a wide range of issues, including disclosure and transparency, financial reporting and accounting, and investor protection and education. Due to budgetary constraints, it is not clear whether the SEC will hold additional hearings in the upcoming year. However, the SEC has stated that it will be preparing a report concerning the state of the municipal securities market, including its recommendations for further action that it should pursue, which may include legislation, rulemaking, and changes in industry practice. To monitor the actions of the SEC related to the municipal securities market, see www.sec.gov/spotlight/municipalsecurities.shtml.

MSRB Activity

.34 The MSRB is a self-regulatory organization created by Congress in 1975 to protect investors and the public interest by developing rules for brokers, dealers, and municipal securities dealers (dealers) engaged in municipal securities activities. In 2010, the mission of the MSRB was expanded by the Dodd-Frank Act, which

was incorporated, in part, into Section 15B of the Securities Exchange Act of 1934 (the 1934 Act), the federal securities law governing the activities of the MSRB. Pursuant to the Dodd-Frank Act, the MSRB now has an obligation to protect state and local governments and other municipal entities, in addition to investors and the public interest. As a result, the MSRB plans to develop rules in the areas of fair practice and fiduciary duties, pay-to-play and other conflicts of interest, gifts, disclosure, professional qualifications, continuing education, and other areas identified by the MSRB governing board. The following sections discuss certain key MSRB activities.

Municipal Advisor Rules and Required Registration

.35 As part of the Dodd-Frank Act, the MSRB was also given rulemaking authority over municipal advisors as of October 1, 2010. Municipal advisors were required to register with the SEC by October 1, 2010, and with the MSRB by December 31, 2010. See the previous section of this alert for more information on municipal advisors, the SEC's involvement, and open questions about whether the definition of *municipal advisor* could be interpreted to include accountants performing certain usual and customary services.

.36 In response to this new responsibility, the MSRB has proposed several rules relating to municipal advisors. Some of these proposed rules are as follows:

- A fiduciary duty rule for municipal advisors that further enhances the requirements in the Dodd-Frank Act; states that municipal advisors have a fiduciary duty to their municipal entity clients when providing municipal advisory services; and requires that dealers disclose all material conflicts of interest in writing, including conflicts of interest associated with various forms of compensation, and obtain informed consent from the municipal entity client before providing or continuing to provide advisory services.
- A rule to add requirements regarding a municipal advisor's dealings with obligated persons. An *obligated person* is any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other arrangement to support the payment of all or part of the obligations on the municipal securities to be sold in an offering of municipal securities. This includes a duty to evaluate the appropriateness of a proposed municipal securities transaction or municipal financial product or transaction for his or her client, unless the client has agreed to a more limited engagement.
- A rule that would preclude the payment by dealers of excessive or lavish entertainment or travel expenses of issuer personnel above certain limits. Additionally, the proposed rule says that depending on the specific facts and circumstances, excessive payments could be considered to be gifts or gratuities made to such issuer personnel in relation to the issuer's municipal securities activities.

New Rules Regarding Disclosures in the Municipal Market

.37 In May 2010, the SEC approved two MSRB proposals relating to disclosure in the municipal market (see MSRB Notice 2010-15). The first proposal requires underwriters to provide to the MSRB's Electronic Municipal Market Access (EMMA) system information about whether a municipal securities issuer or other obligated person has undertaken to provide continuing disclosures under Rule 15c2-12 of the 1934 Act (Rule 15c2-12), as well as the identity of any obligated persons other than the issuer, and the timing by which issuers or obligated persons have agreed to provide annual financial and operating data. This rule change became effective on February 14, 2011. Failure to meet the continuing disclosure requirements could result in the following:

- Disclosure of noncompliance in future official statements
- Reduction in demand for the bonds due to concerns about future noncompliance issues
- Possible legal action by investors who suffer losses resulting from the failure to make timely filings

.38 The second proposal that was approved by the SEC permits issuers, on a voluntary basis, to submit to EMMA preliminary official statements and other related presale documents, official statements, and

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advance refunding documents; information related to the preparation and submission of audited financial statements and annual financial information; and hyperlinks to other disclosure information available on the issuer's website. An issuer or obligated person may post on EMMA that it has undertaken to voluntarily submit annual financial information within 120 calendar days after the end of its fiscal year or, as a transitional alternative, within 150 calendar days after the end of its fiscal year. The transitional alternative is available through December 31, 2013. Additionally, the issuer or obligated person may post on EMMA that it has undertaken to voluntarily prepare audited financial statements pursuant to generally accepted accounting principles (GAAP) as established by GASB or the Financial Accounting Standards Board (FASB), as applicable. This amendment to the EMMA continuing disclosure service will be effective at the end of May 2011.

.39 In August 2010, the SEC approved the MSRB's proposed rule change to amend the EMMA continuing disclosure service to reflect SEC amendments to Rule 15c2-12, which went into effect on December 1, 2010 (see MSRB Notices 2010-32 and 2010-54). The changes to Rule 15c2-12 include the following:

- Removal of the continuing disclosure exemption for variable rate demand obligations (VRDOs)
- Establishment of a timeliness standard for submission of notices of certain events
- Deletion of the general materiality condition for certain of the event notices
- Modification of the language regarding adverse tax event notices
- Addition of certain new event notices

.40 In order to allow issuers and obligated persons to adhere to the requirements of amended Rule 15c2-12, the MSRB modified the language of the EMMA continuing disclosure service to reflect the materiality standard changes under amended Rule 15c2-12 and modified the list of voluntary event-based disclosures that may be submitted to EMMA.

.41 In October 2010, the SEC approved the MSRB's proposal to provide for the posting of credit ratings on EMMA (see MSRB Notice 2010-44). The effective date for the rule change will be no later than October 13, 2011. The MSRB is working with certain nationally recognized statistical rating organizations (NRSROs) to provide such information on EMMA. To the extent that an NRSRO agrees to provide credit ratings and related information to the MSRB without charge, the MSRB will display such information on EMMA, along with any documents and identifying information related to the applicable municipal security.

.42 From an auditor's perspective, as noted in paragraph 16.10 of the Audit and Accounting Guide *State and Local Governments*, the auditor is not required to participate in, or undertake any procedures with respect to, a government's continuing disclosure documents, even though they may include audited financial statements. However, as noted in paragraph 8.121 of the same guide, the auditor should obtain an understanding of a government's internal control over expenses or expenditures and liabilities, which may include an understanding of policies and procedures to ensure adherence to the continuing disclosure requirements of Rule 15c2-12. Finally, when auditors encounter a client that has failed to meet the continuing disclosure requirements, an assessment of how dependent the government is on debt may be appropriate because there could be additional issues to consider. For example, a government's disclosure of noncompliance in future official statements may make it more difficult to sell bonds without increasing costs. Additionally, depending on how reliant the government is with regard to debt, the noncompliance may warrant disclosure in the notes to the financial statements and be something that the auditor would discuss with those charged with governance.

Documents Relating to ARS and VRDOs

.43 In February 2010, the MSRB issued an amendment to MSRB Rule G-8 on books and records and Rule G-34(c) in order to enhance the interest rate and descriptive information currently collected from brokers, dealers, and municipal securities dealers (collectively referred to as dealers). Effective May 16, 2011, MSRB Rule G-34(c) on variable rate security market information will require, among other things, dealers to submit to the MSRB Short-term Obligation Rate Transparency System certain documents associated with municipal ARS and VRDOs (see MSRB Notice 2011-09). ARS program dealers will be required to submit documents

defining current auction procedures and interest rate setting mechanisms. VRDO remarketing agents will be required to submit documents related to letter of credit agreements, stand-by bond purchase agreements, and any other documents that establish an obligation to provide liquidity. All submitted documents will be posted to the MSRB's EMMA website.

IRS Regulation on Required Withholding

.44 IRS proposed regulations REG-158747-06 were published in the *Federal Register* on December 5, 2008, for new Internal Revenue Code (IRC) subsection 3402(t). This subsection, created by the Tax Increase Prevention and Reconciliation Act of 2005, originally required that payments by governmental entities for goods or services after December 31, 2010, are subject to 3 percent income tax withholding, with some exceptions. The implementation date has now been changed by the IRS and will be applied to payments after December 31, 2012. Although this proposed regulation will not affect audits in 2010, auditors may want to bring the issue to the attention of their auditees.

.45 After becoming effective, these new withholding requirements would apply to payments greater than $10,000 made by

- the entire U.S. government, including all federal agencies, the executive branch, the legislative branch, and the judicial branch.
- all states, including the District of Columbia (but not including Indian tribal governments).
- all political subdivisions of a state government or every instrumentality of such subdivisions, unless the instrumentality makes annual payments for property or services of less than $100 million.

.46 Generally, withholding would be required on all payments to all persons providing property or services to the government, including individuals, trusts, estates, partnerships, associations, and corporations. Withholding would occur at the time of payment and applies to payment in any form (cash, check, credit card, or payment card). If the government entity fails to withhold the tax required under IRC subsection 3402(t), it becomes liable for the payment of the tax.

.47 The following exceptions from the withholding requirements would also be provided:

- Payments otherwise subject to withholding, such as wages.
- Payments for retirement benefits, unemployment compensation, or social security.
- Payments subject to backup withholding if the required backup withholding is actually performed.
- Payments for real property.
- Payment of interest.
- Payments to other government entities, foreign governments, tax-exempt organizations, or Indian tribes.
- Payments made under confidential or classified contracts, as described in IRC Section 6050M(e)(3).
- Payments made by a political subdivision of a state or instrumentalities of a political subdivision of a state that make annual payments for property or services of less than $100 million.
- Public assistance payments made on the basis of need or income. However, assistance programs based solely on age, such as Medicare, are subject to the requirements.
- Payments to employees in connection with service, such as retirement plan contributions, fringe benefits, and expense reimbursements under an accountable plan.
- Payments received by nonresident aliens and foreign corporations.
- Payments made by Indian tribal governments.
- Payments in emergency or disaster situations.

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Exception for Small Entities

.48 Subdivisions of a state or instrumentalities of a subdivision of a state are exempt from the withholding requirement if their total annual payments for property and services (not including wages) are less than $100 million. The proposed regulations provide a simple rule for determining whether an entity makes annual payments less than $100 million. In general, the entity would look to its accounting year ending with or within the second preceding calendar year. For example, if total payments for the entity's 2010 accounting year exceed $100 million, the withholding requirement will apply in 2012.

.49 For more details, please see www.irs.gov/govt/fslg/article/0,,id=204409,00.html.

Red Flags Rule

.50 In October 2007, the Federal Trade Commission (FTC) issued the Red Flags Rule for financial institutions and creditors to fight identity theft. The rule sets out how certain businesses and organizations must develop, implement, and administer their identity theft prevention programs. Creditors subject to the Red Flags Rule must be in compliance as of January 1, 2011. There has been considerable discussion and debate about whether the Red Flags Rule applies to governments or whether the Red Flag Program Clarification Act of 2010 passed by Congress in December 2010 exempted them. The answer, as is typical in such cases, is that it depends on the type of activities the government engages in.

.51 The changes made to the law were meant to provide relief to small businesses, such as doctor's offices, CPAs, and small retailers. It is important to note that neither the law nor FTC regulations specifically identify covered entities. Rather, the determination is made based on the activities that the entity engages in as part of its business. Under the new definition, an entity is considered a creditor if it meets any one or more of the following:

- It obtains or uses credit reports, directly or indirectly, in connection with a credit transaction.
- It furnishes information to consumer reporting agencies in connection with a credit transaction.
- It advances funds to, or on behalf of, a person based on an obligation of the person to repay the funds, or the funds are repayable from specific property pledged by, or on behalf of, the person.

.52 Any occurrence of identity theft exposes a creditor to an FTC investigation. Based on the results of the investigation, the FTC can seek both monetary civil penalties and injunctive relief. It is likely that enforcement actions will be widely publicized, which could result in significant damage to the reputation of the government if it is found to be in violation of the Red Flags Rule.

.53 From an audit perspective, upon determination that the Red Flags Rule is applicable, compliance with the Red Flags Rule and the robustness of the government's Identity Theft Prevention Program may be considered in the overall risk assessment of the government, depending on its significance to the entity. Governments should provide a copy of the program to their auditors as part of their documentation of internal controls.

.54 More information and a document outlining specific requirements of the Red Flags Rule can be found at http://ftc.gov/redflagsrule.

Audit and Attestation Issues and Developments

Audit Risks for Governments

.55 As noted in paragraph .17 of AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic

conditions that could affect your governmental auditee, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

.56 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

Supplementary and Other Information Related to Financial Statements

.57 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted. These standards should be of particular interest to state and local governments and their auditors due to the significant amount of supplementary information and required supplementary information that typically accompanies the financial statements of state and local governments.

.58 An extensive discussion of these three standards as they relate to governments, including implementation guidance and examples, is available in appendix D, "Required Supplementary Information, Supplementary Information, and Other Information," of the March 1, 2011, edition of the Audit and Accounting Guide *State and Local Governments*.

Other Information in Documents Containing Audited Financial Statements

.59 Statement on Auditing Standards (SAS) No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility regarding other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information. Documents containing audited financial statements refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. Other information may include financial summaries or highlights; employment data; planned capital expenditures; financial ratios; selected quarterly data; or voluntarily presented information, such as the introductory section or statistical section of a comprehensive annual financial report. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. Additionally, this SAS states that the auditor should communicate with those charged with governance the auditor's responsibility with respect to the other information, any procedures performed relating to the other information, and the results. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

Reporting on Supplementary Information in Relation to the Financial Statements as a Whole

.60 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as

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a whole. For purposes of generally accepted auditing standards (GAAS), *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

.61 A common example of this type of information for many governmental entities is the schedule of expenditures of federal awards that under OMB Circular A-133 is required to be reported on in relation to the financial statements as a whole.

.62 Some of the key auditor requirements included in SAS No. 119 are as follows:

- The auditor should determine that the supplementary information relates to the same period as the audited financial statements.
- The auditor should obtain the agreement of management that it acknowledges and understands its responsibility for the supplementary information.
- The auditor should perform additional procedures regarding the criteria, form, and methods used by management to prepare the supplementary information and evaluate the appropriateness and completeness of the supplementary information.
- The auditor should determine that the supplementary information was derived from, and relates directly to, the underlying accounting and other records used in preparing the financial statements.
- The auditor should obtain written representations from management acknowledging its responsibility for the presentation, the content, the consistency of methods of measurement and presentation, and any significant underlying assumptions or interpretations.

.63 The SAS also includes requirements in the circumstances when the auditor finds that on the basis of the procedures performed, the supplementary information is materially misstated in relation to the financial statements as a whole and the related reporting options.

Required Supplementary Information

.64 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558), addresses the auditor's responsibility with respect to required supplementary information. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. SAS No. 120 explains that the objectives of the auditor, when a designated accounting standard setter requires information to accompany an entity's basic financial statements, are to perform specified procedures in order to

- describe, in the auditor's report, whether required supplementary information is presented and
- communicate therein when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter.

.65 Among the key auditor requirements found in SAS No. 120 are that the auditor should

- inquire of management about the methods of preparing the information.

- compare the information for consistency with management's responses to inquiries, the basic financial statements, and other knowledge obtained during the audit of the basic financial statements.
- obtain written representations from management that it acknowledges its responsibility for the required supplementary information with regard to measurement and presentation, consistency of methods, and any significant underlying assumptions or interpretations.

.66 One area that sometimes causes confusion relates to information required by a regulator (for example, a schedule of expenditures of federal awards in a Circular A-133 audit or a schedule of net worth in an audit performed under the *Consolidated Audit Guide for Audits of HUD Programs*). Although this information is required, it is not considered required supplementary information because only a designated accounting standard setter can require required supplementary information. Therefore, it would not be appropriate for an auditor to use the provisions of SAS No. 120 for supplementary information required by a regulator. Instead, the auditor would use the provisions of SAS Nos. 118 or 119, as appropriate.

Other Comprehensive Basis of Accounting and Supplementary Information

.67 During the conforming change review of the 2011 edition of the Audit and Accounting Guide *State and Local Governments*, guidance related to supplementary information in financial statements prepared in conformity with an other comprehensive basis of accounting (OCBOA) has changed. Paragraph 15.05 of the previous edition of the guide indicated that OCBOA financial statements should be accompanied by required supplementary information applicable to the presentation (for example, MD&A or budgetary comparison information). Further, the guidance indicated that the auditor's responsibility for, and reporting on, that information is the same as for required supplementary information that accompanies financial statements prepared in conformity with GAAP. Given the recent issuance of SAS No. 120 and its definition of *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements, attention was focused on the guidance in paragraph 15.05 of the Audit and Accounting Guide *State and Local Governments*. After consultation with the ASB's Audit Issues Task Force, it was determined that the guidance in paragraph 15.05 needed modification because no designated accounting standard setter exists for OCBOA presentations. Therefore, required supplementary information cannot technically exist in OCBOA reports. As a result, paragraph 15.05 of the 2011 edition of the Audit and Accounting Guide *State and Local Governments* states that OCBOA financial statements may be accompanied by information that a designated accounting standard setter requires to accompany an entity's basic financial statements in a GAAP presentation (that is, MD&A and budgetary comparison information). However, it goes on to say that such information should be considered other information for the purposes of OCBOA financial statements. The bottom line effect of this change for auditors is that going forward, auditors should no longer consider and report on information such as MD&A or budgetary comparison information as required supplementary information when it is included in an OCBOA presentation. Instead, the auditor would consider the information to be other information and refer to SAS Nos. 118 or 119, as appropriate. This will change the auditor's consideration of the information and related reporting. Because this change came about as a result of the issuance of SAS No. 120, it can be implemented on a prospective basis.

Auditor Responsibility for Disclosure in Official Statements

.68 The recent attention to municipal securities activities merits a refresher on the factors that associate an auditor with a government's official statement and the related responsibilities once an association exists. Auditors are subject to the antifraud provisions of the federal securities laws and may be held liable for material misstatements or omissions in documents containing audited financial statements, such as preliminary or final official statements with which they are associated. Disclosures that are unclear or difficult to understand may increase an auditor's exposure to liability. When associated with the official statements, auditors should remember their responsibilities under SAS No. 118. As described in chapter 16, "Auditor Association With Municipal Securities Filings," of the Audit and Accounting Guide *State and Local Governments*, the following are situations in which the auditor becomes associated with the official statement:

- Assisting in preparing the financial information included in the official statement
- Reviewing a draft of the official statement at the government's request

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- Signing (either manually or electronically) the independent auditor's report for inclusion in a specific official statement[1]
- Providing a written agreement (for example, through a consent letter or signed authorization form) for the use of the independent auditor's report in a specific official statement
- Providing a revised independent auditor's report for inclusion in a specific official statement
- Issuing a comfort letter; the letter described in paragraph .09 of AU section 634, *Letters for Underwriters and Certain Other Requesting Parties* (AICPA, *Professional Standards*); or an attestation engagement report, in lieu of a comfort or similar letter, on information included in the official statement
- Issuing a report on an attestation engagement relating to the debt offering

.69 If the auditor is associated with an official statement, the guidance in paragraphs .01–.06 of SAS No. 118 provide that the auditor has no obligation to perform any procedures to corroborate other information[2] contained in those documents. However, the auditor should read the other information and consider whether that information or the manner of its presentation is materially inconsistent with information or the manner of its presentation appearing in the financial statements. SAS No. 118 provides guidance if the auditor concludes that a material inconsistency or a material misstatement of fact that is not a material inconsistency exists. This responsibility includes reading the other information and considering whether such information or the manner of its presentation is materially inconsistent with information or the manner of its presentation appearing in the financial statements. Accordingly, when audited financial statements are included in an official statement, and the auditors are associated with the official statement, auditors should take a "big picture" approach and consider whether any other information in that official statement is materially inconsistent with the audited financial statements.

.70 In some cases, issuers include audit opinions and audited financial information in disclosure documents without obtaining the consent of the auditor. Because consent must be obtained from auditors in the corporate market before an audit opinion may be included in an offering document, investors in municipal securities may not be aware that this is not always the case in a municipal offering. Auditors may encourage their governmental auditees to make appropriate disclosures to investors in situations when governmental auditees intend to use the audit opinion or audited financial information without the auditor's consent.

.71 In 1998, the SEC adopted rules requiring all securities registrants to use plain English in writing prospectuses and in the organization, language, and design of the front matter of prospectuses. These plain English rules do not apply to the municipal market, but the SEC encourages their voluntary use. Municipal disclosures often abound in legalistic or overly complex presentations that make the substance of the disclosure difficult to understand. Vague boilerplate explanations are readily subject to differing interpretations. Remember that most investors who read official statements are not accountants and may have limited accounting backgrounds. Stale and incomplete accounting information is at the core of many of the cases the SEC has brought against municipal bond market participants. Many of the auditors' reports on the financial statements used in primary offering disclosure documents and continuing disclosure filings made pursuant to Rule 15c2-12 are many months old at the time of the offering, raising the risk of an antifraud violation if there have been material changes since the audit was completed. Efficient markets require timely and reliable information to function properly. As an added service, auditors may work with their governmental auditees to try to improve the timeliness of their audited financial statements. Auditors should also remember their obligations under AU section 560 regarding subsequent events, including circumstances in which a governmental auditee requests the auditor's consent to include the audit opinions in disclosure documents.

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[1] This situation involves an original manual or electronic signature on the auditor's report, not a reproduction of an auditor's report that was manually or electronically signed. For example, the underwriter or bond counsel may require a copy of the auditor's report with an original manual or electronic signature to file with the official closing documents for the offering.

[2] *Other information* is a term used in Statement on Auditing Standards No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), and is defined therein as information in addition to audited financial statements and the independent auditor's report thereon.

IT Internal Control Issues

.72 The implementation of the risk-based auditing standards defined the responsibilities of auditors to document their understanding of internal control surrounding how an entity initiates, authorizes, records, processes, and reports transactions and financial data. Many larger governmental entities have been using complex IT systems for years, and during this time, their systems and transaction flows have been documented for both manual and IT-dependent systems. Due to the current economic situation, auditors may want to assess the resources that have been allocated to IT at governmental entities. This would include the quality of documentation, as well as the experiences of the resources, in addressing the IT issues at the audited entity.

.73 Further, a complex IT environment can exist in any government, regardless of the size of the entity. The government's use of IT may affect any of the five components of internal control, in addition to the government's operating and business functions. For example, the government may use an IT system that is highly complex and integrated through all functions and services of the entity; these systems may share data and support all aspects of financial reporting. Alternatively, the government may use one application only for the accounts receivable function or utility billings. The auditor is required to document key elements of internal control surrounding the IT environment. Additionally, AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), states that an auditor may determine that it is necessary to include a specialist to work on the audit team to assist with the determination of the complexities and intricacies of an entity whose use of IT is extensive.

.74 Of particular concern are the risks when a lack of segregation of duties exists over IT functions or accounting functions in the accounting application. Segregation of duties issues may arise due to a reduction in the IT staff at a larger entity or due to the more limited staff of a smaller entity. Regardless of the reason, the extent and nature of these control risks vary depending on the nature and characteristics of the entity's information system. For example, multiple external or internal users may access a common database of information that affects financial reporting. In such circumstances, a lack of an effective control at a single user entry point might compromise the security of the entire database, potentially resulting in unauthorized changes to, or destruction of, data, which could affect the financial statements. The auditor should consider whether the entity has responded adequately to the risks arising from IT by establishing effective controls, including effective general controls upon which application controls depend. From the auditor's perspective, controls over IT systems are effective when they maintain the integrity of information and security of the data that such systems process. Some factors that auditors may want to consider regarding IT controls are as follows:

- Auditors may wish to assess resources that have been allocated to IT issues in light of the current economic climate.
- More complex IT systems can affect all five elements of the Committee of Sponsoring Organizations of the Treadway Commission's internal control framework.
- Auditors may need a specialist in IT to be a member of the audit team.
- Auditors may wish to pay particular attention to the segregation of duties element of IT controls.

.75 Further guidance can be found in the AICPA Information Technology Center at www.aicpa.org/InterestAreas/InformationTechnology/Pages/InfoTech.aspx.

Auditing Accounting Estimates

.76 As noted in paragraph .04 of AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*), the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. In the context of a governmental audit, the overall financial statement level would be at the level of the opinion units, as discussed in paragraph 4.32 of the Audit and Accounting Guide *State and Local Governments*. It is important to remember that many types of accounting estimates exist in auditee financial statements. Some examples related to governmental entities include the allowance for uncollectible accounts receivable, impairment analysis and estimated useful lives

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of capital assets, self-insurance liabilities, uninsured losses, workers' compensation programs, pollution remediation costs, and actuarial assumptions in pension and other postretirement benefit costs.

.77 Given the current economic climate, additional skepticism should be exercised when considering the reasonableness of management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, the auditor normally concentrates on key factors and assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

.78 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management due to budgetary challenges and declining revenues, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management's accounting estimates with an extra degree of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*), when assessing audit differences between auditee estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

Using the Work of a Specialist

.79 It may be necessary to use a specialist, such as an actuary or a securities valuation expert, to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; the reasonableness of the determination of amounts derived from specialized techniques or models; or the implementation of technical requirements, regulations, or legal documents. Governments often engage actuaries to assist them in estimating liabilities relating to pensions, OPEB other than pensions, and self-insurance claims for uninsured losses and workers' compensation programs. Management may also engage engineers or other specialists to assist with determining pollution remediation liabilities. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*), is applicable rather than AU section 336.

.80 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the auditee in terms of objectivity. It is also important to identify how the work of the specialist affects the financial statements because the auditor's responsibility is greater for amounts disclosed in the financial statements and notes than if the information appears in required supplementary information. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements. It is also important to understand that the value of the work of the specialist depends, in part, on the information that he or she is given. Testing the data and underlying assumptions that are provided to the specialist may be appropriate before the auditor relies on the specialist's work. There may also be situations in which auditors decide to use firm or independent specialists to assist in reviewing the work of management's specialist.

.81 For more information and examples of risks when using the work of a specialist, please see the "Pensions and Other Postemployment Benefits" section of this alert.

Consideration of an Entity's Ability to Continue as a Going Concern

.82 The consideration of an entity's ability to continue as a going concern is required in every audit performed under GAAS and is an especially important consideration in the current state of the economy. An

entity's ability to continue as a going concern is affected by many factors related to the economy, such as the industry and geographic area in which it operates, the financial health of its customers and suppliers, and financing sources.

.83 As explained by paragraph .02 of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), the auditor's evaluation is based on his or her knowledge of relevant conditions and events that exist at, or have occurred prior to, the date of the auditor's report. Therefore, this is an ongoing evaluation that extends through the date of the auditor's report.

.84 The auditor has a responsibility to evaluate whether a substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time. AU section 341 notes that is a period not to exceed 1 year beyond the date of the financial statements being audited. However, GASB Statement No. 56 specifies an evaluation by management of a government's ability to continue as a going concern for a period of 12 months beyond the financial statement date plus a period shortly thereafter if currently known information about that period may raise substantial doubt.

.85 Audit teams may find it useful to have preliminary discussions about going concern considerations during engagement planning meetings; however, as noted in AU section 341, it is not necessary to design audit procedures around specifically identifying the possibility of a going concern because results of typical audit procedures should illuminate any indicators. These procedures may consist of analytical procedures, review of subsequent events, review of compliance with financing agreements, review of board minutes, inquiry of legal counsel, and confirmation with related third parties of the details of arrangements to provide or maintain financial support.

.86 Some risks related to the current state of the economy that may influence an entity's ability to continue as a going concern include the following:

- Lenders may be looking for ways to withdraw from lending relationships.
- Deterioration of the tax base in both the residential and commercial areas resulting in significant decreases in revenue.
- Valuation issues with derivative instruments.
- Financial issues with component units when the primary government has some liability, such as a guarantee, for the component units' debt.
- Deferral of maintenance despite significant deterioration of infrastructure.
- Financial support of a related party may not be a feasible mitigating factor, depending on the financial health of that related party.
- An entity's financial health could be significantly weakened if its suppliers or customers have been strongly affected by the economic crisis.
- Projections provided by entities based on historical data may not be reliable future predictions.
- Some entities may be hesitant to include informative and transparent going concern disclosures.

.87 To better understand whether the risks in the economy or other pressures have a significant effect on an auditee, auditors could assess the following:

- The entity's ability to handle cash flow pressures and to meet obligations when they become due
- Whether noncompliance with debt covenants or triggering events of default would cause debt to become current
- The impact of demand bonds classified as current
- Whether the entity has consistent working capital deficiencies or negative operating cash flows
- The quality of future budget estimates for subsequent year cash flow analysis

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.88 If the auditor believes that a substantial doubt about the entity's ability to continue as a going concern exists, the next steps are to obtain management's plans to mitigate the effect of such conditions and then assess the likelihood that these plans can be effectively implemented. Additionally, auditors may consider posing the following questions to help make their assessment of the likelihood of management's plans successfully mitigating the going concern risk:

- What is the strategy for extending lines of credit or refinancing any debt coming due? Have any preliminary agreements or discussions occurred?
- If negative operating trends exist, how does management plan on turning them around?
- If turnover of key personnel has occurred, what actions are being taken to replace these positions?
- What is the plan to maintain or increase the liquidity of your balance sheet?
- Do any restrictions exist that could limit management's ability to carry out these plans?

.89 If, after considering management's plan, an auditor determines that a substantial doubt about an entity's ability to continue as a going concern remains, the auditor should communicate with those charged with governance of the entity, in accordance with AU section 341. In that instance, the auditor also should consider the effects on the entity's financial statements and the adequacy of the related disclosure, and an explanatory paragraph should be added to the audit report following the opinion paragraph.

.90 Alternatively, if management's plan mitigates the risk of the entity's ability to continue as a going concern, the auditor should consider whether management should disclose the primary conditions that gave rise to the initial doubt and management's plans either in the notes to the financial statements or MD&A. These disclosures are especially important for financial statement users to fully comprehend the entity's financial strength and ability to continue as a going concern.

.91 Additional information on going concern considerations for governments can be found in paragraphs 13.16–.25 of the Audit and Accounting Guide *State and Local Governments*.

Summary of Frequent Violations Relating to Governmental Audits—Ethics Division

.92 The AICPA Professional Ethics Division investigates potential disciplinary matters involving members of the AICPA and state CPA societies participating in the Joint Ethics Enforcement Program. The investigations of audits of government and not-for-profit entities are typically initiated by referral from the offices of inspectors general. The Professional Ethics Division has compiled a summary of recent violations that were frequently found in investigations related to governments and not-for-profit entities.

.93 General audit deficiencies noted included working paper documentation deficiencies and lack of adequate audit evidence. The following findings related to disclosure errors and omissions or errors in financial statement reporting or presentation:

- The criteria used for determining component units are not disclosed.
- Debt service requirements to maturity are not disclosed.
- Real property acquired with federal or state grants was expensed.
- Interfund and intrafund balances and transactions were not eliminated, and as such, the statements of financial position and activities did not focus on the organization as a whole. Also, their purpose wasn't disclosed in the notes.
- The combined statement of revenues, expenditures, and changes in fund balances did not properly classify revenues by fund and source or expenditures by function or character.
- The MD&A was missing required elements or included unallowed items or was not presented as required, and the opinion was not modified.

- Budgetary data presented as required supplementary information was incorrectly referred to as statements rather than schedules.
- The required information for operating leases, including future minimum lease payments for the next five years, was not disclosed.

.94 Additionally, the following findings related to audit report errors and omissions:

- The auditor's report did not contain an appropriate indication of the degree of responsibility taken with respect to the supplementary information accompanying the basic financial statements, other than with respect to the schedule of expenditures of federal awards.
- Failure to dual date the reissued report.
- The auditor's report was not qualified for specified departures from GAAP.
- The auditor failed to include verbiage required in the auditor's report on the financial statements or the report issued to meet the requirements of *Government Auditing Standards*.
- The report restriction for the internal control and compliance reports did not meet the requirements of AU section 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*).

Service Organizations

.95 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324), has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attestation standard and an auditing standard to better reflect the nature of the work being performed. Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), contains the requirements for reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, and earlier implementation is permitted. A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324. SSAE No. 16 is based on the International Auditing and Assurance Standards Board's (IAASB's) International Standard on Assurance Engagements No. 3402, *Assurance Reports on Controls at a Service Organization*, and the new SAS is based on the IAASB's International Standard on Auditing (ISA) 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

.96 The AICPA is in the process of overhauling and rewriting the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (commonly known as the SAS 70 guide). Also, to address reporting on a service provider's controls over subject matter other than financial reporting, the AICPA developed a new Audit Guide, *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*. The AICPA is also in the process of drafting communication materials that will help auditors, auditees, and users understand the three types of service organization control (SOC) reports (formerly SAS No. 70 reports) to be used for reporting on these engagements.

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	Title	Description
SOC 1	*Service Organizations—Applying SSAE No. 16,* Reporting on Controls at a Service Organization *(SOC 1)*	To be used only in circumstances when the service organization's services and controls affect the internal control over financial reporting for the entities that use the service.
SOC 2	*Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*	The purpose is to convey trust and assurance to users of the system that the service organization has deployed an effective control system to effectively mitigate operational and compliance risks that the system may represent to its users.
SOC 3	*Trust Services Report*	These reports are designed to meet the needs of users who want assurance on the controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy of a system but do not have the need for the level of detail provided in a SOC 2 report. These reports are general use reports and can be freely distributed or posted on a website as a seal.

Accounting Issues and Developments

GASB Accounting Standards Upcoming Implementation Dates

.97 A number of GASB pronouncements issued prior to 2010 have provisions with effective dates for fiscal periods ending in 2011 and 2012. These pronouncements and applicable implementation provisions are highlighted as follows.

GASB Statement No. 54

.98 GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*, issued in March 2009, initially distinguishes fund balance between amounts that are considered nonspendable, such as fund balance associated with inventories, and other amounts that are classified based on the relative strength of the constraints that control the purposes for which specific amounts can be spent. Beginning with the most binding constraints, the remaining fund balance amounts should be reported in the following classifications:

Restricted. Amounts that can be spent only for the specific purposes stipulated by constitution, external resource providers, or through enabling legislation.

Committed. Amounts that can be used only for the specific purposes determined by a formal action of the government's highest level of decision-making authority.

Assigned. Amounts intended to be used by the government for specific purposes but that do not meet the criteria to be classified as restricted or committed.

Unassigned. The residual classification for the government's general fund that includes all amounts not contained in the other classifications.

.99 GASB Statement No. 54 also clarifies the definitions of individual governmental fund types. It interprets certain terms within the definition of *special revenue fund types* and further clarifies the *debt service fund* and *capital projects fund* definitions. The standard also specifies how economic stabilization or "rainy day" amounts should be reported. Only stabilization arrangements that contain specific circumstances under which the amounts can be accessed should be reported as restricted or committed fund balance in the general fund. Lack of specific circumstances or detail on the nature or use of the stabilization fund balance should result in the fund balance being reported as unassigned. Stabilization amounts should be reported in the general

fund as restricted or committed if they meet the appropriate criteria. Only if the resources in the stabilization arrangement derive from a restricted or committed revenue source and can only be used for specific purposes could a stabilization arrangement be reported as a special revenue fund.

.100 The definitions of *general fund* and *permanent fund* also are clarified by GASB Statement No. 54. Definitions are as follows:

General fund. Should be used to account for and report all financial resources not accounted for and reported in another fund.

Special revenue funds. Used to account for and report the proceeds of specific revenue sources that are restricted or committed to expenditure for specified purposes other than debt service or capital projects. See paragraph 31 of GASB Statement No. 54 for additional discussion regarding the use of special revenue funds.

Capital projects funds. Used to account for and report financial resources that are restricted, committed, or assigned to expenditures for capital outlays, including the acquisition or construction of capital facilities and other capital assets.

Debt service funds. Used to account for and report financial resources that are restricted, committed, or assigned to expenditure for principal and interest.

Permanent funds. Should be used to account for and report resources that are restricted to the extent that only earnings, and not principal, may be used for purposes that support the reporting government's programs (that is, for the benefit of the government or its citizenry).

.101 For governments that use encumbrance accounting, encumbrances, if significant, should be disclosed in the notes to the basic financial statements in total by major funds and nonmajor funds in the aggregate in conjunction with required disclosures about other significant commitments. They should not be separately displayed within committed, assigned, or restricted categories.

.102 GASB Statement No. 54 is effective for financial statements for periods beginning after June 15, 2010. Earlier application is encouraged. Governments may find it necessary to begin the planning and implementation process well in advance of the fiscal year in which this statement becomes effective to allow adequate time to develop and communicate an appropriate policy. Fund balance reclassifications made to conform to GASB Statement No. 54 should be applied retroactively by restating the fund balance for all prior periods presented.

.103 GASB Statement No. 54 will have a significant effect on fund balance reporting by governmental entities. To facilitate transition to this new model, auditors may consider the following discussion items with auditees:

- Work with auditees to help them understand the impact of the policy decision for spending resources and how to track spending.
- Review the auditee's evaluation of fund types, especially special revenue funds, to ensure that funds are appropriately reported under the clarified definitions. Note that with regard to special revenue funds, substantial restricted or committed revenue transfers in do not count.
- Review the auditee's procedures for identifying and distributing encumbrances to restricted, committed, and assigned fund balance.
- Remind auditees that only the general fund can have a positive unassigned fund balance; other governmental fund types can only report a negative unassigned fund balance.
- Evaluate the auditee's assessment and presentation of "rainy day" funds, economic stabilization reserves, budget reserves, and similar arrangements.

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- Remind auditees that some assets in nonspendable form (for example, property held for resale and long-term loans or notes receivables) may need to be classified in another category if there are restrictions on the use of the proceeds from those assets.

.104 Auditors who assist auditees with the preparation of financial statements should have heightened awareness to the need for management to understand this standard and be able to take responsibility for any changes or reclassifications required by this standard to alleviate auditor independence issues.

GASB Statement No. 57

.105 Issued in December 2009, GASB Statement No. 57, *OPEB Measurements by Agent Employers and Agent Multiple-Employer Plans*, addresses issues related to the use of the alternative measurement method and the frequency and timing of measurements by employers that participate in agent multiple-employer OPEB plans (that is, agent employers).

.106 This statement amends GASB Statement No. 45 to permit an agent employer that has an individual-employer OPEB plan with fewer than 100 total plan members to use the alternative measurement method at its option, regardless of the number of total plan members in the agent multiple-employer OPEB plan in which it participates. Consistent with this change to the employer-reporting requirements, this statement also amends a GASB Statement No. 43, requirement that a defined benefit OPEB plan obtain an actuarial valuation. The amendment permits the requirement to be satisfied for an agent multiple-employer OPEB plan by reporting an aggregation of results of actuarial valuations of the individual-employer OPEB plans or measurements resulting from the use of the alternative measurement method for eligible individual-employer OPEB plans.

.107 In addition, GASB Statement No. 57 clarifies that when actuarially-determined OPEB measures are reported by an agent multiple-employer OPEB plan and its participating employers, those measures should be determined as of a common date and at a minimum frequency to satisfy the agent multiple-employer OPEB plan's financial reporting requirements.

.108 The provisions related to the use and reporting of the alternative measurement method are effective upon issuance. The provisions related to the frequency and timing of measurements are effective for actuarial valuations first used to report funded status information in OPEB plan financial statements for periods beginning after June 15, 2011.

Recently Issued GASB Pronouncements and Related Guidance

.109 The following summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. The Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) and other AICPA industry-specific alerts also contain summaries of recent nongovernmental accounting pronouncements that may not be discussed here. To obtain copies of AICPA literature, call 888.777.7077 or visit www.cpa2biz.com

GASB Statement No. 62

.110 GASB Statement No. 62, *Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*, issued December 2010, incorporates guidance that previously could only be found in certain FASB and AICPA pronouncements (collectively referred to as the FASB and AICPA pronouncements in GASB Statement No. 62). In addition, GASB Statement No. 62 supersedes GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, as amended, and amends or supersedes various other GASB and National Council on Governmental Accounting (NCGA) standards and interpretations. The specific paragraphs and footnotes of the various GASB and NCGA standards and interpretations that are amended or superseded upon the effective date of GASB Statement No. 62 are identified in paragraph 4 of GASB Statement No. 62.

.111 GASB Statement No. 62 incorporates into GASB's authoritative literature the applicable guidance previously presented in the following pronouncements issued November 30, 1989, and prior:

- FASB Statements and Interpretations
- Accounting Principles Board Opinions
- Accounting Research Bulletins of the AICPA's Committee on Accounting Procedure

.112 Certain FASB and AICPA pronouncements were excluded from GASB Statement No. 62 because GASB believes these pronouncements either conflict with or contradict GASB pronouncements or because they rarely apply to state and local governments.

.113 Paragraph 515 of GASB Statement No. 62 states that this statement generally is not intended to establish new financial reporting requirements or modify existing requirements; rather, it incorporates into the GASB literature FASB and AICPA accounting and reporting guidance applicable to state and local governments.

.114 Generally, GASB Statement No. 62 will affect state and local governments as follows:

- FASB and AICPA pronouncements issued on or before November 30, 1989, that are not addressed in the standard section of GASB Statement No. 62 become *other accounting literature* in the hierarchy of GAAP for state and local governments, unless those standards conflict with or contradict GASB standards.
- The election in paragraph 7 of GASB Statement No. 20, as amended, allowing enterprise funds and business-type activities to apply post-November 30, 1989, FASB Statements and Interpretations that do not conflict with or contradict GASB pronouncements is eliminated.
- Post-November 30, 1989, FASB and AICPA pronouncements that do not conflict with or contradict GASB pronouncements can continue to be applied as *other accounting literature*.
- The chart found at www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1175804837176, which provides nonauthoritative guidance regarding the applicability of post-November 30, 1989, FASB standards to enterprise funds and business-type activities that apply paragraph 7 of GASB Statement No. 20, will be superseded upon the effective date of GASB Statement No. 62.

.115 GASB received several comments during the due process of this statement voicing concerns over the elimination of the election by an enterprise fund to apply all FASB Statements and Interpretations issued after November 30, 1989. It should be noted that GASB addressed this concern in paragraphs 544–551 of GASB Statement No. 62. Since issuing GASB Statement No. 20, GASB has either issued standards or has on its current agenda or research projects guidance on accounting for defined benefit plans, derivatives, fair value measurement, alternative investments, and asset retirement obligations—thus eliminating the need for the paragraph 7 election.

.116 Prior to the issuance of GASB Statement No. 62, a number of individual GASB pronouncements made certain AICPA and FASB pronouncements specifically applicable to governmental entities. For example, GASB Statement No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*, requires the application of certain pronouncements of FASB and its predecessor standard-setting organizations issued on or before November 30, 1989, and permits the application of later FASB pronouncements in certain situations.

.117 Governments that elect to apply the provisions of GASB Statement No. 62 prior to the effective date will need to remove general and specific references to FASB and AICPA pronouncements issued on or before November 30, 1989, from the financial statements and notes thereto.

.118 GASB Statement No. 62 is effective for periods beginning after December 15, 2011, with earlier application encouraged.

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GASB Statement No. 61

.119 In December 2010, GASB issued GASB Statement No. 61, *The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34*. GASB Statement No. 61 is designed to improve financial reporting for governmental entities by amending the requirements of GASB Statement Nos. 14, *The Financial Reporting Entity*, and 34 to better meet user needs and address reporting entity issues that have come to light since those statements were issued in 1991 and 1999, respectively.

.120 The goal of this statement is to improve the information presented about the financial reporting entity, which comprises a primary government and related entities known as component units. The amendments to the criteria for including component units allow users of financial statements to better assess the accountability of elected officials of the primary government by ensuring that the financial reporting entity includes only organizations for which the elected officials are financially accountable or that the government determines would be misleading to exclude.

.121 In addition, the statement amends the criteria for blending (that is, reporting component units as if they were part of the primary government) in certain circumstances. The amendments to the criteria for blending will help ensure that the primary government includes only those component units that are so intertwined with the primary government that they are essentially the same as the primary government, and the amendments clarify which component units have that characteristic.

.122 For primary governments that are business-type activities reporting in a single column (for example, a state university), the new guidance provides that a component unit may be blended by consolidating its financial statement data within the single column of the primary government and disclosing condensed combining information in the notes to the financial statements, which will allow users to better distinguish between the primary government and its component units.

.123 Lastly, the new requirements for reporting equity interests in component units help ensure that the primary government's financial statements do not understate the financial position and provide for more a consistent and understandable display of those equity interests.

.124 The requirements of GASB Statement No. 61 are effective for financial statements for periods beginning after June 15, 2012. Earlier application is encouraged.

GASB Statement No. 60

.125 In December 2010, GASB issued GASB Statement No. 60, *Accounting and Financial Reporting for Service Concession Arrangements*. GASB Statement No. 60 addresses how to account for and report SCAs, a type of public-private or public-public partnership that state and local governments are increasingly entering into.

.126 Common examples of SCAs include long-term arrangements in which a government, referred to as the transferor, engages a company or another government, referred to as the operator, to operate a major capital asset—such as toll roads, hospitals, and student housing—in return for the right to collect fees from users of the capital asset. In these SCAs, the operator generally makes a large up-front payment to the transferor. Alternatively, the operator may build a new capital asset for the transferor and operate it on the transferor's behalf.

.127 GASB Statement No. 60 provides guidance for the transferor government on reporting the capital assets; recognizing up-front payments from an operator (generally, first as deferred inflows of resources and then as revenue); and recording any obligations that constitute liabilities of the transferor to the operator. The statement also provides guidance for governments that are operators in an SCA.

.128 The goal of this statement is to improve financial reporting by establishing recognition, measurement, and disclosure requirements for SCAs for both transferors and governmental operators. It requires governments to account for and report SCAs in the same manner, which improves the comparability of financial

statements. In addition, it is designed to alleviate the confusion that can arise when determining what guidance should be applied in complex circumstances, which previously was not specifically addressed in GASB literature.

.129 This statement is effective for financial statements for periods beginning after December 15, 2011. In general, its provisions are required to be applied retroactively for all periods presented.

GASB Statement No. 59

.130 In June 2010, GASB issued GASB Statement No. 59, *Financial Instruments Omnibus*. The purpose of this statement is to update and improve existing standards regarding the financial reporting of certain financial instruments and external investment pools.

.131 GASB Statement No. 59 includes the following guidance:

- Emphasizes the applicability of SEC requirements to certain external investment pools known as 2a7-like pools to provide users with more consistent information on qualifying pools
- Addresses the applicability of GASB Statement No. 53 to certain financial instruments to clarify which financial instruments are within the scope of that pronouncement and to provide greater consistency in financial reporting
- Applies the reporting provisions for interest-earning investment contracts of GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investment Pools*, to unallocated insurance contracts to improve the consistency of reporting by pension and OPEB plans.

.132 This statement is effective for financial statements prepared by state and local governments for periods beginning after June 15, 2010, with earlier application encouraged.

GAAP for State and Local Governments

.133 GASB Statement No. 55, *The Hierarchy of Generally Accepted Accounting Principles for State and Local Governments*, defines the sources of accounting principles used in the preparation of financial statements of state and local governmental entities that are presented in conformity with GAAP and the framework for selecting those principles. GASB Statement No. 55 identifies the sources of GAAP, in descending order of authority, as follows:

a. Officially established accounting principles—GASB Statements and Interpretations

b. GASB Technical Bulletins and, if specifically made applicable to state and local governmental entities by the AICPA and cleared by GASB, AICPA Audit and Accounting Guides and AICPA Statements of Position

c. AICPA Practice Bulletins if specifically made applicable to state and local governmental entities and cleared by GASB, as well as consensus positions of a group of accountants organized by GASB that attempts to reach consensus positions on accounting issues applicable to state and local governmental entities

d. Implementation guides (questions and answers) published by the GASB staff, as well as practices that are widely recognized and prevalent in state and local government

.134 Under GASB Statement No. 55, if the accounting treatment for a transaction or other event is not specified by a pronouncement in category (a), a governmental entity should consider whether the accounting treatment is specified by an accounting principle from a source in another category. In such cases, if categories (*b*)–(*d*) contain accounting principles that specify accounting treatments for a transaction or other event, the governmental entity should follow the accounting treatment specified by the accounting principle from the source in the highest category (follow category [*b*] treatment over category [*c*] treatment).

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.135 Prior to the statement, the GAAP hierarchy was set forth in SAS No. 69, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, rather than the authoritative accounting literature of GASB. In August 2009, the ASB voted to withdraw SAS No. 69, as amended, from the auditing literature for nonissuers. GASB Statement No. 55 moves relevant portions of that SAS to GASB literature without substantive changes. GASB does not anticipate that this statement will result in a change in current practice. GASB Statement No. 55 became effective upon issuance.

Recent Pronouncements

.136 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the GASB website at www.gasb.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.137 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 121, *Revised Applicability of Statement on Auditing Standards No. 100, Interim Financial Information* (AICPA, *Professional Standards*, AU sec. 722 par. .05) Issue Date: February 2011 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard further amends SAS No. 100 by amending paragraph .05 of AU section 722 such that AU section 722 would be applicable when the accountant audited the entity's latest annual financial statements and the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. SAS No. 121 is effective for interim reviews of interim financial information for periods beginning after December 15, 2011. Early application is permitted.
SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements*

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
in accordance with GAAS)	(AICPA, *Professional Standards*, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 118 Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.

Recent Accounting Standards, Pronouncements, and Related Guidance

.138 The following table presents a list of recently issued accounting standards, pronouncements, and related guidance.

Recent Accounting Standards, Pronouncements, and Related Guidance	
Governmental Accounting Standards Board (GASB) Statement No. 62 (December 2010)	*Codification of Accounting and Financial Reporting Guidance Contained in Pre-November 30, 1989 FASB and AICPA Pronouncements*
GASB Statement No. 61 (December 2010)	*The Financial Reporting Entity: Omnibus—an amendment of GASB Statements No. 14 and No. 34*
GASB Statement No. 60 (December 2010)	*Accounting and Financial Reporting for Service Concession Arrangements*
GASB Statement No. 59 (June 2010)	*Financial Instruments Omnibus*

Recently Issued Technical Questions and Answers

.139 The following table presents a list of nonauthoritative audit and attest technical questions and answers recently issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

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Recently Issued Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
Audit and Attest	
Technical Questions and Answers (TIS) section 9110.17 (July 2010)	"Application of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740-10 (previously, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*), to Other Comprehensive Basis of Accounting (OCBOA) Financial Statements—Recognition and Measurement Provisions"
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in FASB ASC 820 to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than GAAP"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"

Recent AICPA Independence and Ethics Developments

.140 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at 888.777.7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.141 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3, "Performance of nonattest services," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05). Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as maintaining internal control for the client.

.142 To address the possible inconsistency in Interpretation No. 101-3, PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members better distinguish between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

.143 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

.144 Exposure drafts issued by PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

On the Horizon

.145 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to state and local governments or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.146 The following table lists the various standard-setting bodies' websites through which information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	***Website***
AICPA Auditing Standards Board	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AuditingStandardsBoard/Pages/ASB.aspx
Financial Accounting Standards Board	www.fasb.org
Governmental Accounting Standards Board	www.gasb.org
Professional Ethics Executive Committee	www.aicpa.org/InterestAreas/ProfessionalEthics/Pages/ProfessionalEthics.aspx
Securities and Exchange Commission	www.sec.gov

Overhaul Project—AICPA Audit and Accounting Guide *Health Care Entities*

.147 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Health Care Entities*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1996. The accounting guidance for governmental health care entities is included and has been cleared by GASB. A working draft of the accounting sections of the new guide was issued for a 60-day comment period in April 2011. The working draft can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/AFGuidance.aspx. Readers should be alert for the issuance of the new guide near the end of 2011.

Overhaul Project—AICPA Audit and Accounting Guide *Gaming*

.148 The AICPA will be issuing the overhauled AICPA Audit and Accounting Guide *Gaming*, which replaces the 2006 edition of the AICPA Audit and Accounting Guide *Casinos*. This new guide addresses numerous accounting, auditing, industry, and regulatory issues that have transpired in this industry. The accounting guidance for certain tribal government entities is included and has been cleared by GASB. Readers should be alert for the issuance of the new guide in July 2011.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.149 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards, so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the

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Codification of Statements on Auditing Standards (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the ISAs issued by the IAASB. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the second half of 2011. Two possible exceptions to that time frame include the clarity redrafts of AU sections 341 and 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*).

.150 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–121) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Group Audits

.151 The State and Local Government Expert Panel is specifically reviewing the clarified SAS *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, given the structure of governments and the prevalence of other auditors' involvement in the audits of component units. The focus of this clarified SAS is how to conduct an effective audit of group financial statements and is significantly broader in scope that AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*). The AICPA is developing an Audit Risk Alert to address this particular SAS and assist auditors in implementing it upon its effective date (concurrent with the other clarity standards). Auditors should be aware of this clarified SAS and begin to determine how it may impact their engagements.

Compilation and Review Engagements

.152 The AICPA developed a new guide, *Compilation and Review Engagements*, which will provide additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*). It also includes illustrative engagement and representation letters, sample compilation and review reports (including state and local government examples), detailed illustrations, and case studies. See www.cpa2biz.com and enter product code 0128110 for further information.

Accounting Pipeline

Current GASB Projects

.153 GASB currently has a variety of projects in process. Some of these projects are as follows:

- *Derivative Instruments: Application of Hedge Accounting Termination Provisions—an amendment of GASB Statement No. 53*. This proposed statement addresses the situation when governments have entered into interest rate swap agreements and commodity swap agreements in which the swap counterparty or the swap counterparty's credit support provider commits or experiences either an act of default

or a termination event, as both are described in the swap agreement. The objective of this project is to improve financial reporting for state and local governments by clarifying what constitutes a termination event for accounting and financial reporting purposes. The comment period on the exposure draft of the proposed standard ended on April 15, 2011.

- *Financial Reporting of Deferred Outflows of Resources, Deferred Inflows of Resources, and Net Position*. The objective of this proposed statement is to provide guidance for reporting deferred outflows of resources, deferred inflows of resources, and net position in a statement of financial position. The comment period on the exposure draft of the proposed standard ended February 25, 2011.
- *Postemployment Benefit Accounting and Financial Reporting*. GASB will consider the possibility of improvements to the existing standards of accounting and financial reporting for postemployment benefits, including pension benefits and OPEB, by state and local governmental employers and trustees, administrators, or sponsors of pension or OPEB plans. One objective of this project is to improve the accountability and transparency of financial reporting in regard to the financial effects of employers' commitments and actions related to pension benefits and OPEB. This objective would include improving the information provided to help financial report users assess the degree to which interperiod equity has been achieved. The other objective of this project is to improve the usefulness of information for decisions or judgments of relevance to the various users of the general-purpose external financial reports of governmental employers and pension or OPEB plans. GASB currently is focusing on issues specifically related to pension accounting and financial reporting. An exposure draft document is expected to be issued for public comment in mid-2011.
- *Deferred Inflows and Outflows of Resources: Omnibus*. The objectives of this project are (*a*) to identify, in the existing authoritative literature, requirements to recognize balances that may appear to meet the definitions of *deferred outflows of resources* or *deferred inflows of resources* in GASB Concepts Statement No. 4, *Elements of Financial Statements*, and (*b*) to determine whether those balances should continue to be recognized as assets or liabilities or reclassified for financial reporting purposes as deferred outflows of resources or deferred inflows of resources, respectively. An exposure draft document is expected to be issued for public comment in mid-2011.
- *Conceptual Framework—Recognition and Measurement Attributes*. The objectives of this project are (*a*) to develop recognition criteria for whether information should be reported in state and local governmental financial statements and when that information should be reported and (*b*) to consider the measurement attribute(s) (for example, historical cost or fair value) that conceptually should be used in governmental financial statements. This project ultimately will lead to a GASB Concepts Statement. A preliminary views document is expected to be issued for public comment in mid-2011.
- *Economic Condition Reporting: Fiscal Sustainability*. The objectives of this project are to identify the information that users require to assess a government's economic condition, to compare these needs with the information that users receive under current standards, and to consider whether guidance should be considered for the remaining information. The principal focus of the project is to consider whether any additional, useful information for assessing a government's economic condition should be required or encouraged for inclusion in a government's financial report. In light of the growing national concern with fiscal sustainability, the project will consider how these concerns relate to the economic condition. Along those lines, this project includes consideration of the information necessary for users to assess the risks associated with a government's intergovernmental financial dependencies. A due process document is expected to be issued for public comment in late 2011.

.154 Readers should be alert for the issuance of due process documents. More information about these and other GASB projects can be found at www.gasb.org/project_pages/index.html.

Comprehensive Implementation Guide Update

.155 Annually, GASB publishes the annual update to its *Comprehensive Implementation Guide*. The *Comprehensive Implementation Guide* consolidates and updates previously issued guides for subsequently issued standards and provides current guidance on standards for which no stand-alone guides have been published.

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.156 In December 2010, GASB published a midyear supplement to its *Comprehensive Implementation Guide*. The midyear supplement was developed to address questions and answers regarding life insurance reported as investments, credit risk disclosures, and derivative instruments. The midyear supplement also provides additional derivative instrument illustrations.

Help Desk: The *Comprehensive Implementation Guide* can be ordered through GASB's order department at 800.748.0659 or via its website at www.gasb.org.

Resource Central

.157 The following are various resources that practitioners engaged in the state and local government environment may find beneficial.

Publications

.158 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *State and Local Governments* (2011) (product no. 0126611 [paperback] or WGG-XX [online with the associated Audit Risk Alert)
- Audit and Accounting Guide *Gaming* (2011) (product no. 0127111 [paperback]
- Audit and Accounting Guide *Health Care Entities* (2010) (product no. 0126110 [paperback] or WHC-XX [online with the associated Audit Risk Alert])
- Audit and Accounting Guide Government Auditing Standards *and Circular A-133 Audits* (2011) (product no. 0127411 [paperback] or WRF-XX [online with the associated Audit Risk Alert])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Guide *Compilation and Review Engagements*(2010) (product no. 0128110 [paperback] or WRC-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Compilation and Review Alert *Compilation and Review Developments—2010/11* (product no. 0223010 [paperback])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- Audit Risk Alert *Employee Benefit Plans Industry Developments—2011* (product no. 0224111 [paperback])
- Checklists and Illustrative Financial Statements *State and Local Governments* (product no. 0090311 [paperback] or WSG-CL [online])
- *Accounting Trends & Techniques, 64th Edition* (product no. 0099010 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099110 [paperback] or WIF-XX [online])

- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Audit and Accounting Practice Aid *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006661 [paperback])
- Audit and Accounting Practice Aid *Applying OCBOA in State and Local Governmental Financial Statements* (product no. 006614 [paperback])
- *Guide to Fraud in Governmental and Not-for-Profit Environments, Revised Edition* (product no. 091032 [paperback])

AICPA Online Professional Library: Accounting and Auditing Literature

.159 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB *Accounting Standards Codification*™; the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*; and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

AICPA Audit Committee Toolkit for Government Entities

.160 Taxpayers and citizens of governmental entities expect a government to be publicly accountable for the services it provides and how it utilizes its resources to provide those services. An audit committee has the opportunity to assist the governing body with fiscal accountability demonstrated through strong internal controls, budgetary and other legal compliance, accurate and timely financial reporting, sound business practices, and a culture of strong moral and ethical behavior. More specifically, an audit committee of a government organization can help the government achieve the following:

- *Improve financial practices and reporting*. An audit committee can meet periodically with the government's chief executive and financial officers to review, monitor, and direct activities and results related to the government's maintenance of internal controls and preparation of financial reports.
- *Enhance the internal audit function*. When an internal audit team reports directly to the audit committee, the internal audit team can provide information to the audit committee about whether the government is meeting its financial and compliance responsibilities and recommend changes in practices and internal controls when necessary.
- *Enhance the external audit function*. An audit committee can meet with the external auditors to get independent observations about management's efforts to maintain strong internal controls, appropriate financial reporting, and sound business practices.

.161 For governments interested in establishing or enhancing an audit committee, the AICPA *Audit Committee Toolkit: Government Organizations* (toolkit) provides valuable information and tools that will help a governing body and its officials create an effective audit committee function to help improve fiscal accountability.

.162 These tools inform and educate audit committees about changes in government reporting standards and the government environment as a whole. For governments that already have an audit committee, the toolkit may improve the efficiency and effectiveness of the audit committee. In either situation, the toolkit's easy-to-use set of checklists, questionnaires, and other useful information can make the audit committee's job easier to accomplish. The goal of the toolkit is to assist government audit committees in taking a much greater role in providing information to the governing body and assisting it with meeting its fiduciary responsibilities. The audit committee tools are available at www.cpa2biz.com.

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Continuing Professional Education

.163 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's AnnualAccounting and Auditing Update Workshop(2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *Internal Control Deficiencies: Assessment and Reporting Under SAS No. 115* (product no. 733294 [text]). This course focuses on compliance with the standard's requirements by examining each stage of the decision-making framework by using numerous illustrations and practice exercises. The course also applies to managers of nonpublic companies to enable them to decide whether a control deficiency exists and how to correct it.

.164 Among the many courses, the following are specifically related to state and local governments:

- *Foundations in Governmental Accounting* (product no. 731647). This course features the fundamental tenets of governmental accounting and reporting in the post-GASB Statement No. 34 environment. Learn more than the buzz words—learn the underlying concepts and how they are applied.
- *Governmental Accounting and Auditing Update (2010/2011 Edition)* (product no. 736480 [text] or 186486 [DVD]). This timely, up-to-the-minute course is designed to provide you with a comprehensive understanding of new developments, so you can provide better services to both clients and the public. For 2010–11, the course includes coverage of new GASB pronouncements; recent Yellow Book and OMB Circular A-133 developments; AICPA pronouncements related to communicating internal control related matters identified in an audit, compliance auditing, and required supplementary information; and more.
- *Governmental Accounting and Reporting: Putting It All Together* (product no. 732805). This course goes deep into the accounting and reporting issues for state and local governments. Learn how to navigate the complexities of government accounting and reporting in the post-GASB Statement No. 34 environment.
- *Audits of HUD-Assisted Projects* (product no. 730931). Gain in-depth, hands-on information regarding the Department of Housing and Urban Development organization, programs, policies, and procedures. Review the professional standards affecting specific federal programs.
- *Frequent Frauds Found in Governments and Not-For-Profits* (product no. 733313). Through an informative case study approach, this course illustrates common frauds that make headlines and damage the reputations of government and not-for-profits.
- *InSight: Single Audit Fundamentals On-Demand Series* (product no. 154260). Provides background and information on audits performed under OMB Circular A-133. The training is designed as an introduction to certain single audit topics and tools that an auditor will need to function as a staff member on a single audit engagement.

.165 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.166 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide

variety of topics. Some topics of special interest to auditors of state and local governments include the following:

- *Government Accounting and Reporting: Preparing the Government-Wide Financial Statements*
- *Fraud in Exempt Organizations: The Governmental and Not-for-Profit Environments*
- *Yellow Book: Ethical Principles and General Standards*
- *2010 Annual Update: Government & NPO: GASB Activities*
- *Governmental and NPO Workpaper Techniques: Overall Approach*

.167 To register or learn more, visit www.cpa2biz.com.

Webcasts

.168 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Other Resources

.169 One of the problem areas noted in quality control reviews of single audits has been deficiencies in the auditor's documentation surrounding the understanding and testing of internal control over compliance. The Government Audit Quality Center (GAQC) has issued a practice aid that will provide tools to assist auditors in documenting internal control over compliance in a single audit. The practice aid, *Documenting and Testing Compliance and Internal Control Over Compliance in a Single Audit* (product no. 006662PDF), is available to nonmembers of the GAQC for a nominal fee at www.cpa2biz.com and is available at no charge to members of the GAQC on the GAQC website at www.aicpa.org/GAQC.

Member Service Center

.170 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

Hotlines

Accounting and Auditing Technical Hotline

.171 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.172 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

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Industry Conferences

.173 The AICPA National Governmental Accounting and Auditing Update Conference (GAAC) EAST is held in late summer in Washington, D.C., and its counterpart, GAAC WEST, takes place in Las Vegas, Nevada, in early fall. These conferences are designed for CPAs working in federal, state, and local government; public practitioners with government auditees; and regulators who need to be aware of emerging developments. These CPAs should attend one of these conferences to remain current on the issues. Attending one of these conferences is a great way to receive timely guidance, along with practical advice on how to handle new legislation and standards, from key government officials and representatives of the accounting profession, including the standard setters themselves.

.174 The AICPA National Governmental and Not-for-Profit Training Program is scheduled to be held in October in Lake Buena Vista, Florida. Obtain the most up-to-date coverage on current and emerging issues and topics. Standard setters and industry leaders discuss a broad range of topics, including developments in governmental accounting and auditing; advances in financial statement reporting and the latest in proposed regulations; future issues affecting nonprofit organizations; and laws on the local, state, and federal government levels.

.175 The AICPA National Healthcare Industry Conference is scheduled to be held in November in Baltimore, Maryland. This conference is an unparalleled opportunity to gain the information and techniques you need to know to stay on top of trends to benefit your practice and client offerings. With access to some of the nation's top health care specialists, you'll get up-to-the-minute information on the latest developments in health care issues.

AICPA GAQC

.176 The GAQC is a voluntary membership center for CPA firms and state audit organizations that is designed to improve the quality and value of governmental audits. For purposes of the GAQC, governmental audits are performed under *Government Auditing Standards* and are audits and attestation engagements of federal, state, or local governments; not-for-profit organizations; and certain for-profit organizations, such as housing projects and colleges and universities that participate in governmental programs or receive governmental financial assistance. The GAQC keeps members informed about the latest developments and provides them with tools and information to help them better manage their audit practice. CPA firms and state audit organizations that join demonstrate their commitment to audit quality by agreeing to adhere to certain membership requirements.

.177 The GAQC has been in existence since September 2004. Since its launch, center membership has grown to almost 1,600 firms from 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, and 16 state audit organizations. The CPA firm portion of the GAQC membership accounts for approximately 88 percent of the total federal expenditures covered in single audits performed by CPA firms in the Federal Audit Clearinghouse database (http://harvester.census.gov/sac/) for the year 2008 (the latest year with complete submission data).

.178 The GAQC's focus is to promote the highest quality audits and save members time by providing a centralized place to find information that they need when they need it to maximize quality and practice success. Center resources include the following:

- E-mail alerts with the latest audit and regulatory developments, including information on the Recovery Act and its impact on your audits
- Exclusive Internet seminars, webcasts, and teleconferences on compliance auditing and timely topics relevant to governmental and not-for-profit financial statement audits (optional CPE is available for a small fee, and events are archived online)
- Dedicated GAQC website at www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx with resources, community, events, products, and a complete listing of GAQC member firms in each state

- Online member discussion forums for sharing best practices and discussing issues that members are facing
- Savings on professional liability insurance

.179 For more information about the GAQC, visit www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx.

Help Desk: With all of the quality issues being noted in governmental audits (see further discussion in the "Legislative and Regulatory Developments" and "Audit and Attestation Issues and Developments" sections of this alert), your CPA firm or state audit organization should consider joining the GAQC. To enroll or learn more about the GAQC, including details on the membership requirements and fees for membership, go to www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx or e-mail GAQC staff at GAQC@aicpa.org.

AICPA Industry Expert Panel—State and Local Governments

.180 The State and Local Government Expert Panel is an AICPA volunteer group whose purpose is to identify state and local government financial reporting and auditing issues; work with appropriate bodies for resolutions benefiting the public interest; conduct liaison activities with GASB regulators, such as the Government Accountability Office and OMB, and applicable industry associations; and advise and assist in the development of AICPA products and services related to state and local government audits. For information about the activities of the State and Local Government Expert Panel, visit the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/StateAndLocalGovernment/Pages/StateandLocalGovernment.aspx.

Industry Websites

.181 The Internet covers a vast amount of information that may be valuable to auditors of state and local governments, including current industry trends and developments. Some of the more relevant sites for auditors with governmental auditees include those shown in the following table:

Organization	*Website*
AICPA Government Audit Quality Center	www.aicpa.org/gaqc
Association of Government Accountants	www.agacgfm.org
Association of Local Government Auditors	www.governmentauditors.org
Catalog of Federal Domestic Assistance	www.cfda.gov
Federal Audit Clearinghouse	http://harvester.census.gov/sac
Financial Accounting Standards Board	www.fasb.org
Government Accountability Office	www.gao.gov
Governmental Accounting Standards Board	www.gasb.org
Government Auditing Standards (Yellow Book)	www.gao.gov/govaud/ybk01.htm
Government Finance Officers Association	www.gfoa.org

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Organization	*Website*
National Association of State Auditors, Comptrollers and Treasurers	www.nasact.org
Offices of Inspectors General	www.ignet.gov
Office of Management and Budget	www.whitehouse.gov/OMB www.whitehouse.gov/omb/recovery_default
Securities and Exchange Commission information for municipal markets	www.sec.gov/info/municipal.shtml

.182 The state and local government practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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.183 The Audit Risk Alert *State and Local Governmental Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to ccole@aicpa.org or write to

Christopher Cole
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org

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Website Name	*Content*	*Website*
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission	Information on current SEC rulemaking and the Electric Data Gathering, Analysis, and Retrieval database	www.sec.gov

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AAM Section 8080

Service Organizations: New Reporting Options—2010/11

STRENGTHENING ENGAGEMENT INTEGRITY
SAFEGUARDING REPORTING

Notice to Readers

This alert, *Service Organizations: New Reporting Options—2010/11*, provides practitioners with an overview of the changes to Statement on Auditing Standards No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324), and alerts them to reporting options when examining controls at a service organization other than those relevant to financial reporting by user entities. It is intended to help practitioners understand the requirements of Statement on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), and to provide professional guidelines that will enhance both consistency and quality in the performance of attest services.

If a practitioner applies auditing or attestation guidance, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the service and appropriate. The auditing or attestation guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully appreciates the invaluable assistance of Diana Krupica in developing this publication.

How This Alert Helps You

.01 This alert, *Service Organizations: New Reporting Options—2010/11*, is designed to help practitioners understand the changes to Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324), and select the appropriate service organization control (SOC) report for a client's particular circumstances. It also is designed to assist management of a service organization in preparing its written assertion.

Introduction

.02 It has become more common for CPAs[1] in the practice of public accounting to be asked to provide assurance on subject matter other than financial statements. Statements on Standards for Attestation Engagements (SSAEs), also called attestations standards, enable a CPA to report on subject matter other than financial statements.

.03 The main objective of the attestation standards is to provide a general framework for the attest function. As such, the standards (*a*) provide useful and necessary guidance to practitioners engaged to perform new and established attest services and (*b*) guide AICPA standard-setting bodies in establishing, if deemed necessary, interpretive standards for such services.

[1] In the attestation standards, a CPA performing an attestation engagement ordinarily is referred to as a practitioner. Statement on Standards for Attestation Engagements No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) uses the term service auditor rather than practitioner to refer to a CPA reporting on controls at a service organization.

.04 The attestation standards are a natural extension of the 10 generally accepted auditing standards. Like the auditing standards, the attestation standards require technical competence, independence in mental attitude, due professional care, adequate planning and supervision, sufficient evidence, and appropriate reporting. The attestation standards have been used to develop a growing array of services, for example, reporting on

- internal control over financial reporting;
- the effectiveness of controls over privacy;
- compliance with laws, regulations, and contracts;
- investment performance statistics; and
- certain information supplementary to financial statements.

.05 Thus, the attestation standards have been developed to be responsive to a changing environment and the demands of society.

What Are Service Organizations?

.06 Many companies function more efficiently and profitably by outsourcing certain tasks or functions to other organizations that have the personnel, expertise, or equipment to accomplish these tasks. An example of this arrangement is a health insurer that outsources the processing of medical claims to a claims processor. At the end of a specified period, the claims processor reports the cost of the claims processed during the period and the related liability to the insurer. That information is then included in the insurer's financial statements. The auditor of the insurer's financial statements is responsible for auditing all the information in the insurer's financial statements, including the information generated by the claims processor. The auditor must find a way to obtain evidence that supports the information generated by the claims processor and included in the insurer's financial statements. One way of doing so is to obtain a *service auditor's* report in which a CPA examines the claims processor's description of its system for processing claims, the suitability of the design of controls[2] at the claims processor that affect the information reported to the health insurer, and in some cases, the operating effectiveness of those controls.[3] From the perspective of the insurer, the controls at the claims processor prevent, or detect and correct, errors or omissions in the information reported to the insurer. The idea is that the more effective the controls are, the more likely the information provided to the health insurer will be correct.

.07 An organization that performs a task or function for others entities is known as a *service organization* (the claims processor), and an entity that outsources a task or function to a service organization is known as a *user entity* (the health insurer). The auditor auditing the financial statements of a user entity is known as a *user auditor*, and the CPA reporting on controls at a service organization is known as a service auditor.

How SAS No. 70 Has Changed

.08 Since 1992, SAS No. 70 has been the source of the requirements and guidance for service auditors and user auditors. SAS No. 70 has been divided and replaced by two new standards. One is an attestation standard, and the other is an auditing standard. The requirements and guidance for a service auditor reporting on controls at a service organization relevant to user entities internal control over financial reporting have been placed in SSAE No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801). The requirements and guidance for auditing the financial statements of entities that use service organizations remains in the auditing standards in the clarified SAS *Audit Considerations Relating to an Entity Using a Service Organization*. The clarified SAS expands on how a user auditor audits the financial statements of a user entity, specifically, how the user auditor

- obtains an understanding of the entity, including its internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement and

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[2] A control that is *suitably designed* is able to achieve the related control objective if it is operating effectively.

[3] A control that is *operating effectively* actually does achieve the related control objective.

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- designs and performs additional audit procedures responsive to those risks.

.09 Although the Auditing Standards Board (ASB) has finalized this new auditing standard, it has not been issued as authoritative.[4] It is effective for audits of financial statements for periods ending on or after December 15, 2012. Early implementation is not permitted.

Why SAS No. 70 Was Changed

.10 The auditing standards primarily provide guidance on reporting on an audit of financial statements, whereas the attestation standards primarily provide guidance on reporting on other subject matter. In SSAE No. 16, the service auditor is not reporting on financial statements but rather on a service organization's description of its system and controls. Moving the requirements for service auditors reporting on controls at a service organization to the attestation standards better reflects the nature of the work a service auditor performs. This change also aligns with the ASB's project to converge its standards with those of the International Auditing and Assurance Standards Board (IAASB). SSAE No. 16 is based on the IAASB's assurance standard for service auditors, International Standards on Assurance Engagement No. 3402, *Assurance Reports on Controls at a Service Organization*. The assurance standards are the equivalent of the attestation standards.

Two New Publications

.11 To help practitioners make the transition from SAS No. 70 to SSAE No. 16 and to reflect the requirements and guidance in SSAE No. 16, the forthcoming AICPA Guide *Service Organizations: Applying SSAE No. 16, Reporting on Controls at a Service Organization*, developed by an ASB task force, will replace the existing Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*.

.12 Although the focus of SSAE No. 16 is on controls at service organizations that are likely to be relevant to user entities' internal control over financial reporting, paragraph 2 of SSAE No. 16 indicates that the guidance in SSAE No. 16 may be helpful to a CPA planning and performing an engagement under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), to report on controls at a service organization other than those likely to be relevant to user entities' internal control over financial reporting. To assist practitioners in performing those engagements, another guide, *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*, is forthcoming. It will address controls at a service organization relevant to the security, availability, or processing integrity of a system or the confidentiality or privacy of the information processed by the system.

.13 AT section 50, *SSAE Hierarchy* (AICPA, *Professional Standards*), categorizes AICPA guides as interpretive publications. Interpretive publications are not attestation standards; rather, they are recommendations on the application of the attestation standards in specific circumstances, including engagements for entities in specialized industries. An interpretive publication is issued under the authority of the ASB after all ASB members have been provided with an opportunity to consider and comment on whether the proposed interpretive publication is consistent with the attestation standards.

New Reporting Options

.14 An increasingly popular service offered by certain service organizations is *cloud computing*, which involves providing user entities with on-demand network access to a shared pool of computing resources, such as networks, servers, storage, applications, and services. The increasing use of these services has resulted in a demand by user entities for assurance regarding controls over the systems underlying those services. The previously mentioned AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* is intended to meet that demand.

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[4] See the AICPA's final clarified Statements on Auditing Standards website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

.15 To make practitioners aware of the various professional standards available to them for examining and reporting on controls at a service organization, and to help practitioners select the appropriate standard and related report for a particular engagement, the AICPA has introduced a series of three different SOC reports (SOC 1, SOC 2, and SOC 3). This series encompasses new SSAE No. 16, which retains the original purpose of SAS No. 70, and adds two new reporting options.

.16 The following are highlights of the three reporting options:

- *SOC 1 report*. An engagement performed under SSAE No. 16 in which a service auditor reports on controls at a service organization that may be relevant to user entities' internal control over financial reporting. A type 2 report contains a detailed description of the service auditor's tests of controls and results thereof. Use of the report is restricted to specified parties. It is primarily used by user auditors.
- *SOC 2 report*. An engagement performed under AT section 101 in which a service auditor reports on controls at a service organization other than those relevant to user entities' internal control over financial reporting (specifically controls at a service organization relevant to security, availability, processing integrity, confidentiality, or privacy). A type 2 report contains a detailed description of the service auditor's tests of controls and results thereof. The criteria for these engagements are contained in *Trust Services Principles Criteria and Illustrations* (AICPA, *Technical Practice Aids*). The AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* contains guidance to assist service auditors in performing and reporting on these engagements.
- *SOC 3 report*. An engagement performed under AT section 101 in which a service auditor reports on whether an entity maintained effective controls over its system as it relates to the principle being reported on, such as security, availability, processing integrity, confidentiality, or privacy. It does not contain a description of the service auditor's tests and results. The criteria and additional guidance for these engagements are contained in *Trust Services Principles Criteria and Illustrations*. These are general-use reports.

.17 The following sections contain additional information about each of the reporting options.[5]

SOC 1 Engagements

.18 AICPA SOC 1 (SSAE No. 16) reports are intended to meet the needs of management of user entities and their financial statement auditors. SOC 1 reports contain the service auditor's opinion on the fairness of the presentation of the service organization's description of its system and the suitability of the design of the service organization's controls that may be relevant to user entities' financial statement assertions. A type 2 report also includes the operating effectiveness of those controls. These reports are an important source of information for user auditors in understanding and evaluating a user entity's internal control over financial reporting for the purpose of planning and performing an audit of the user entity's financial statements. A service auditor may be engaged to provide the following two types of reports:

- *Type 1 report*. A report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of the controls to achieve the related control objectives included in the description as of a specified date
- *Type 2 report*. A report that is the same as a type 1 report but also includes (1) the service auditor's opinion on the operating effectiveness of the controls and (2) a description of the service auditor's tests of the operating effectiveness of the controls and the results of those tests

.19 A popular misunderstanding about SAS No. 70 is that a service organization becomes "SAS 70 certified" after undergoing a type 1 or type 2 engagement. However, no such certification exists nor will it exist under SSAE No. 16.

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[5] Detailed information about service organization control (SOC) 1, SOC 2, and SOC 3 reporting options is available at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/SOC/Pages/SORHome.aspx.

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.20 A service auditor's report is primarily an auditor-to-auditor communication, designed to provide user auditors with detailed information about controls at a service organization that affect the information provided to user entities. All service auditors' reports include a detailed description of the service organization's system, and a type 2 report includes a detailed description of tests of controls performed by the service auditor and the results of those tests. The user auditor reads this information to determine how the service organization's system generates the information provided to user entities and whether the opinion states that the controls are suitably designed, and in a type 2 report, operating effectively. Such information generally is lengthy and detailed and could not be communicated via a certification.

.21 Service organizations that undergo such an engagement generally provide copies of the service auditor's report to their user entities, and the user entities provide them to their user auditors. The report enables user auditors to obtain evidence about the quality and accuracy of the information provided to the user entities.

New Requirements Mandated by SSAE No. 16

.22 One new requirement in SSAE No. 16 is for the service auditor to obtain a written assertion from management of the service organization about the fairness of the presentation of its description of the service organization's system and about the suitability of the design. A type 2 engagement also includes the operating effectiveness of the controls included in the description. That assertion will either accompany the service auditor's report or be included in the description of the service organization's system. In addition to the required management assertion, the following are some of the other substantive changes introduced by SSAE No. 16:

- The service auditor may not use evidence about the satisfactory operation of controls in prior periods to provide a basis for a reduction in testing in the current period, even if it is supplemented with evidence obtained during the current period.
- The service auditor is required to identify in the description of tests of controls performed by the service auditor any tests of controls performed by internal auditors and the service auditor's procedures with respect to that work.
- In a type 2 engagement, the service auditor's opinion on the description of the service organization's system and on the suitability of the design of controls covers a period (the same period as the period covered by the service auditor's tests of controls). In SAS No. 70, the opinion on the description and on the suitability of the design of controls in a type 2 report is as of a specified date, rather than for a period.

.23 Use of a SOC 1 report is restricted to the service organization client, existing user entities, and user auditors. Therefore, these reports are not general use report and, as such, should not be used by anyone other than the specified parties named in the restricted use paragraph of the service auditor's report.

.24 In the past, some CPAs incorrectly used SAS No. 70 to report on controls at a service organization that are unrelated to user entities' internal control over financial reporting, for example, controls over the privacy of customers' information or the processing integrity of a system. SAS No. 70 is not applicable to examinations of controls over subject matter other than financial reporting, and neither is SSAE No. 16.

.25 If a CPA is engaged to examine and issue a report on controls over subject matter other than financial reporting, such an engagement should be performed under AT section 101 of the attestation standards, not under SSAE No. 16 (nor under SAS No. 70). The forthcoming AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* is an application of AT section 101.

Illustrative Assertions by Management of a Service Organization for SOC 1 Reports

.26 The following are illustrative written assertions by management of a service organization. Example 1 is an illustrative assertion for a type 2 report, and example 2 is an illustrative assertion for a type 1 report.

Example 1: Illustrative Assertion by Management of a Service Organization for a Type 2 Report

XYZ Service Organization's Assertion

We have prepared the description of XYZ Service Organization's [*type or name of*] system (*description*) for user entities of the system during some or all of the period [*date*] to [*date*] and their user auditors who have a sufficient understanding to consider it, along with other information, including information about controls implemented by user entities of the system themselves, when assessing the risks of material misstatements of user entities' financial statements. We confirm, to the best of our knowledge and belief, that

a. the description fairly presents the [*type or name of*] system made available to user entities of the system during some or all of the period [*date*] to [*date*] for processing their transactions [*or identification of the function performed by the system*]. The criteria we used in making this assertion were that the description

i. presents how the system made available to user entities of the system was designed and implemented to process relevant transactions, including

(1) the classes of transactions processed.

(2) the procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, and transferred to the reports presented to user entities of the system.

(3) the related accounting records, supporting information, and specific accounts that are used to initiate, authorize, record, process, and report transactions; this includes the correction of incorrect information and how information is transferred to the reports presented to user entities of the system.

(4) how the system captures and addresses significant events and conditions, other than transactions.

(5) the process used to prepare reports or other information provided to user entities' of the system.

(6) specified control objectives and controls designed to achieve those objectives.

(7) other aspects of our control environment, risk assessment process, information and communication systems (including the related business processes), control activities, and monitoring controls that are relevant to processing and reporting transactions of user entities of the system.

ii. does not omit or distort information relevant to the scope of the [*type or name of*] system, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities of the system and the independent auditors of those user entities, and may not, therefore, include every aspect of the [*type or name of*] system that each individual user entity of the system and its auditor may consider important in its own particular environment.

b. the description includes relevant details of changes to the service organization's system during the period covered by the description when the description covers a period of time.

c. the controls related to the control objectives stated in the description were suitably designed and operated effectively throughout the period [*date*] to [*date*] to achieve those control objectives. The criteria we used in making this assertion were that

i. the risks that threaten the achievement of the control objectives stated in the description have been identified by the service organization;

ii. the controls identified in the description would, if operating as described, provide reasonable assurance that those risks would not prevent the control objectives stated in the description from being achieved; and

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iii. the controls were consistently applied as designed, including whether manual controls were applied by individuals who have the appropriate competence and authority.

Example 2: Illustrative Assertion by Management of a Service Organization for a Type 1 Report

XYZ Service Organization's Assertion

We have prepared the description of XYZ Service Organization's [*type or name of*] system (*description*) for user entities of the system as of [*date*] and their user auditors who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when obtaining an understanding of user entities' information and communication systems relevant to financial reporting. We confirm, to the best of our knowledge and belief, that

a. the description fairly presents the [*type or name of*] system made available to user entities of the system as of [*date*] for processing their transactions [*or identification of the function performed by the system*]. The criteria we used in making this assertion were that the description

i. presents how the system made available to user entities of the system was designed and implemented to process relevant transactions, including

(1) the classes of transactions processed.

(2) the procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, and transferred to the reports presented to user entities of the system.

(3) the related accounting records, supporting information, and specific accounts that are used to initiate, authorize, record, process, and report transactions; this includes the correction of incorrect information and how information is transferred to the reports provided to user entities of the system.

(4) how the system captures and addresses significant events and conditions, other than transactions.

(5) the process used to prepare reports or other information provided to user entities of the system.

(6) specified control objectives and controls designed to achieve those objectives.

(7) other aspects of our control environment, risk assessment process, information and communication systems (including the related business processes), control activities, and monitoring controls that are relevant to processing and reporting transactions of user entities of the system.

ii. does not omit or distort information relevant to the scope of the [*type or name of*] system, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities of the system and the independent auditors of those user entities, and may not, therefore, include every aspect of the [*type or name of*] system that each individual user entity of the system and its auditor may consider important in its own particular environment.

b. the controls related to the control objectives stated in the description were suitably designed as of [*date*] to achieve those control objectives. The criteria we used in making this assertion were that

i. the risks that threaten the achievement of the control objectives stated in the description have been identified by the service organization.

ii. the controls identified in the description would, if operating as described, provide reasonable assurance that those risks would not prevent the control objectives stated in the description from being achieved.

Illustrative SOC 1 Reports Under SSAE No. 16

.27 Paragraphs 52–53 of SSAE No. 16 identify the elements that should be included in a type 2 and type 1 service auditor's report, respectively. The following are illustrative service auditor's reports for engagements performed under SSAE No. 16. These reports are for guidance only and are not intended to be exhaustive or applicable to all situations. Example 3 is an illustrative report for a type 2 engagement, and example 4 is an illustrative report for a type 1 engagement.

Example 3: Type 2 Service Auditor's Report

Independent Service Auditor's Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls

To: XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] throughout the period [*date*] to [*date*] (*description*) and the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for the assertion, including the completeness, accuracy, and method of presentation of the description and the assertion; providing the services covered by the description; specifying the control objectives and stating them in the description; identifying the risks that threaten the achievement of the control objectives; selecting the criteria; and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description throughout the period [*date*] to [*date*].

An examination of a description of a service organization's system and the suitability of the design and operating effectiveness of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description and the suitability of the design and operating effectiveness of those controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the related control objectives stated in the description were achieved. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein and the suitability of the criteria specified by the service organization and described at page X. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

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Inherent limitations

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. Also, the projection to the future of any evaluation of the fairness of the presentation of the description, or conclusions about the suitability of the design or operating effectiveness of the controls to achieve the related control objectives, is subject to the risk that controls at a service organization may become inadequate or fail.

Opinion

In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion on page X,

a. the description fairly presents the [*type or name of*] system that was designed and implemented throughout the period [*date*] to [*date*].

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period [*date*] to [*date*].

c. the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [*date*] to [*date*].

Description of tests of controls

The specific controls tested and the nature, timing, and results of those tests are listed on pages YY–ZZ.

Restricted use

This report, including the description of tests of controls and results thereof on pages YY–ZZ, is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system during some or all of the period [*date*] to [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service Auditor's Signature*]

[*Date of the Service Auditor's Report*]

[*Service Auditor's City and State*]

Example 4: Illustrative Type 1 Service Auditor's Report

Independent Service Auditor's Report on a Description of a Service Organization's System and the Suitability of the Design of Controls

To: XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] as of [*date*] and the suitability of the design of controls to achieve the related control objectives stated in the description.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design of the controls to achieve the related controls objectives stated in the description. XYZ Service Organization is responsible for preparing the description and

for its assertion, including the completeness, accuracy, and method of presentation of the description and the assertion; providing the services covered by the description; specifying the control objectives and stating them in the description; identifying the risks that threaten the achievement of the control objectives; selecting the criteria; and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance, in all material respects, about whether the description is fairly presented and the controls were suitably designed to achieve the related control objectives stated in the description as of [*date*].

An examination of a description of a service organization's system and the suitability of the design of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description of the system and the suitability of the design of the controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed to achieve the related control objectives stated in the description. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein and the suitability of the criteria specified by the service organization and described at page XX.

We did not perform any procedures regarding the operating effectiveness of the controls stated in the description and, accordingly, do not express an opinion thereon.

We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. The projection to the future of any evaluation of the fairness of the presentation of the description, or any conclusions about the suitability of the design of the controls to achieve the related control objectives, is subject to the risk that controls at a service organization may become ineffective or fail.

Opinion

In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion,

a. the description fairly presents the [*type or name of*] system that was designed and implemented as of [*date*], and

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively as of [*date*].

Restricted use

This report is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system as of [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when obtaining an understanding of user entities information and communication systems relevant to financial reporting. This report is not intended to be and should not be used by anyone other than these specified parties.

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[*Service Auditor's Signature*]

[*Date of the Service Auditor's Report*]

[*Service Auditor's City and State*]

SOC 2 Engagements

.28 Many entities use service organizations to perform tasks or functions that are unrelated to financial reporting. AICPA SOC 2 reports are intended to meet the needs of users seeking assurance about controls at a service organization related to the security, availability, or processing integrity of a system or the confidentiality or privacy of the information processed by the system. SOC 2 reports can help user entity management

- obtain information about a service organization's controls over the system through which services are provided,
- assess and address the risks associated with an outsourced service, and
- carry out its responsibility for monitoring the services provided by a service organization.

.29 An example of the applicability of SOC 2 reports is an engagement to report on a service organization's controls over privacy. Many user entities are required by law or regulation to maintain the privacy of the information they collect from customers, including the privacy of that information when it is at a service organization. To address these requirements, management of a user entity may ask the service organization for a service auditor's report on the effectiveness of its controls over the privacy of the information it processes or maintains for user entities.

.30 The two types of reports for these engagements are

- *type 1 report*. A report on the fairness of the presentation of management's description of the service organization's system and the suitability of the design of controls in meeting the applicable trust services criteria.
- *type 2 report*. A report that is the same as a type 1 report but also includes (1) the service auditor's opinion on the operating effectiveness of the controls in meeting the applicable trust services criteria and (2) a description of the service auditor's tests of the operating effectiveness of the controls and the results of those tests.

.31 In a SOC 2 engagement, the criteria for evaluating the design and operating effectiveness of the controls are the criteria in *Trust Services Principles Criteria and Illustrations* which provides criteria for evaluating and reporting on controls related to security, availability, processing integrity, confidentiality, and privacy. In *Trust Services Principles Criteria and Illustrations*, these five attributes of a system are known as principles.

.32 In both type 1 and type 2 SOC 2 reports, management's written assertion may be included in the description of the service organization's system or attached to the description. When the report addresses the privacy principle, the statement of privacy practices should be included in or accompany the description.

.33 These reports are intended for use by stakeholders (for example, customers, regulators, business partners, suppliers, and management) of the service organization that have a thorough understanding of the service organization and its controls.

.34 A type 1 report is unlikely to provide user entities with sufficient information to assess risks related to the outsourced service. However, a type 1 report may be useful to a user entity in understanding the service organization's system and controls. The following are circumstances in which a type 1 report may be useful.

.35 The service organization has not been in operation for a sufficient length of time to enable the service auditor to gather sufficient appropriate evidence regarding the operating effectiveness of controls.

.36 The service organization has recently made significant changes to the system and related controls and does not have a sufficient history with a stable system to enable a type 2 engagement to be performed.

.37 Because of the limitations of a type 1 engagement, a service auditor may recommend that a type 2 engagement covering a short period (for example, two months) be performed rather than a type 1 engagement.

.38 Unlike SSAE No. 16, the primary users of SOC 2 reports generally are not user auditors but rather management of the user entities. For example, a user entity may make certain commitments to its customers regarding the security of the system it uses to process customers' information. When such processing is outsourced to a service organization, the user entity's ability to meet these commitments may, in large part, depend on controls at the service organization that affect physical and logical access to the system.

.39 Because restriction on the use of SOC 2 reports is being discussed at the time of this publication, see the forthcoming AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* for guidance on use of SOC 2 reports.

.40 In addition, illustrative service auditor reports will be included, in their final form, in the forthcoming AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*.

.41 A practitioner may perform a SOC 2 engagement that covers one or more of the trust services principles. Each principle describes an attribute of a system and is followed by criteria for evaluating controls over the system with respect to that attribute. Criteria are the benchmarks used to measure and present the subject matter. The practitioner evaluates the subject matter against these criteria.

Management's Written Assertion in a SOC 2 Engagement

.42 In a SOC 2 engagement, management of the service organization must provide the service auditor with a written assertion about whether in all material respects, and based on suitable criteria,

a. management's description of the service organization's system fairly presents the service organization's system that was designed and implemented throughout the specified period.[6]

b. the controls related to management's description of the service organization's system were suitably designed throughout the specified period to meet the applicable trust services criteria.

c. in a type 2 engagement, the controls related to the control objectives stated in management's description of the service organization's system operated effectively throughout the specified period to meet the applicable trust services criteria.

d. when management's description of the service organization's system addresses the privacy principle, management of the service organization complied with the commitments in its statement of privacy practices throughout the specified period.

.43 Management of the service organization should have a reasonable basis for its written assertion.

.44 Illustrative assertions by management will be included, in their final form, in the forthcoming AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*.

[6] The service auditor should determine that all of the applicable trust services criteria have been included in management's description and addressed by the service organization's controls. For example, if a service auditor is reporting on the design and operating effectiveness of controls at a service organization relevant to the security of user entities' information, the service auditor should determine that all the trust services criteria related to security have been included in the description and addressed by the service organization's controls.

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SOC 3 Engagements

.45 AICPA SOC 3 reports are designed to meet the needs of users who want assurance on controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy but do not need the detailed description of tests of controls and results included in a SOC 2 report. Like a SOC 2 engagement, the criteria for evaluating the design and operating effectiveness of the controls are the criteria in *Trust Services Principles Criteria and Illustrations* SOC 3 reports address a market need because they may be used by current and prospective customers of the service organization.

SOC 3 Seal Option

.46 In addition to a traditional report, a SOC 3 report can be delivered in the form of a seal (SysTrust for Service Organization), displayed on the service organization's website. The SysTrust for Service Organization seal is a registered certification mark of the AICPA and the Canadian Institute of Chartered Accountants (CICA). Practitioners must be licensed by the CICA to use this seal. For more information on licensure, see CICA's website, www.webtrust.org, or contact Bryan Walker at brian.walker@cica.ca.

.47 Management of a service organization may consider engaging a service auditor to perform a SOC 2 engagement and a SOC 3 engagement and to report on both engagements. By doing so, management of the service organization can use the SOC 2 report to meet the specified requirements of user entities and the SOC 3 report to satisfy the general requirements of other parties that may not be user entities.

.48 SOC 2 and SOC 3 reports address similar subject matter and use the same criteria (the criteria in *Trust Services Principles Criteria and Illustrations*), but a SOC 2 report differs from a SOC 3 report in that a SOC 2 report provides report users with the following report components that are not included in a SOC 3 report:

- A description of the service organization's system prepared by management of the service organization (A SOC 3 report includes a description of the system and its boundaries that is typically less detailed than the descriptions in a SOC 2 report and is not covered by the practitioner's report.)
- In a type 2 report, a description of the service auditor's tests of the operating effectiveness of the service organization's controls and the results of those tests
- In a type 2 report that addresses the privacy principle, a description of the service auditor's tests of the service organization's compliance with the commitments in its statement of privacy practices and the results of those tests

Management's Written Assertion in a SOC 3 Engagement

.49 AT section 101 states that when a written assertion has not been obtained a practitioner may still report on the subject matter; however the form of the report will vary depending on the circumstances and its use

should be restricted. Specifically, management asserts that, during the period covered by the report and based on the AICPA and CICA trust services criteria, it maintained effective controls over the system under examination to satisfy the stated trust services principle(s) and criteria. For engagements covering only certain principles, management's assertion should only address the principles covered by the engagement. In addition, for engagements covering an entity's compliance with its commitments, those commitments covered by the report should be identified in management's assertion.

.50 Under AT section 101, the practitioner may report on either management's assertion or on the subject matter of the engagement. When the practitioner reports on the assertion, the assertion should accompany the practitioner's report or be included in the first paragraph of the practitioner's report. When the practitioner reports on the subject matter, the practitioner may want to request that management make its assertion available to the users of the practitioner's report. If one or more deviations from the criteria exist, the practitioner should modify the report. When issuing a modified report, the practitioner should report directly on the subject matter rather than on the assertion.

Example 5: Illustrative Assertion by Management for a SOC 3 Engagement

During the period [*month*] [*day*], 2009, through [*month*] [*day*], 2009, ABC Company, in all material respects:

Maintained effective controls over the privacy of personal information collected in our _________ [*description of the entities and activities covered, for example "the mail-order catalog-sales operations"*] business (the Business) to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with our commitments in our privacy notice related to the Business and with criteria set forth in Generally Accepted Privacy Principles, issued by the American Institute of Certified Public Accountants and the Canadian Institute of Chartered Accountants, and

Complied with our commitments in our privacy notice, which is dated [*month*] [*day*], 2009, and [*is available at www.ABC-Company/privacy or accompanies this report*].

Illustrative SOC 3 Reports

.51 The following are illustrative SOC 3 examination reports. The first paragraph of the practitioner's report indicates whether the practitioner is reporting on management's assertion or directly on the subject matter.

.52 These reports are for illustrative purposes and should be modified in accordance with the applicable professional standards and the facts and circumstances of the engagement.

.53 SOC 3 reports (in all cases) are for general use. They may be used by current and prospective customers and therefore may serve as a marketing tool to demonstrate that the service organization has effective controls in place to mitigate risks related to security, availability, processing integrity, confidentiality, or privacy.

Example 6: Illustrative Trust Services Report on Management's Assertion About the Effectiveness of Controls Related to Four Principles (Availability, Security, Processing Integrity, and Confidentiality) (Period-of-Time Report)

Independent Practitioner's Trust Services Report

To the management of ABC Company, Inc.:

We have examined management's assertion that during the period [*month, day, and year*], through [*month, day, and year*], ABC Company, Inc. (ABC Company) maintained effective controls over the ____________________ [*type or name of system*] system based on the AICPA and CICA trust services availability, security, processing integrity, and confidentiality criteria to provide reasonable assurance that

the system was available for operation and use, as committed or agreed;

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the system was protected against unauthorized access (both physical and logical);

the system processing was complete, accurate, timely, and authorized; and

information designated as confidential was protected by the system as committed or agreed

based on the AICPA and CICA trust services security, availability, processing integrity, and confidentiality criteria.

ABC Company's management is responsible for this assertion. Our responsibility is to express an opinion based on our examination. Management's description of the aspects of the ______________ [*type or name of system*] system covered by its assertion is attached. We did not examine this description, and accordingly, we do not express an opinion on it.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included (1) obtaining an understanding of ABC Company's relevant controls over the availability, security, processing integrity, and confidentiality of the ______________ [*type or name of system*] system; (2) testing and evaluating the operating effectiveness of the controls; and (3) performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of the nature and inherent limitations of controls, ABC Company's ability to meet the aforementioned criteria may be affected. For example, controls may not prevent or detect and correct error or fraud, unauthorized access to systems and information, or failure to comply with internal and external policies or requirements. Also, the projection of any conclusions based on our findings to future periods is subject to the risk that changes may alter the validity of such conclusions.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, based on the AICPA and CICA trust services security, availability, processing integrity, and confidentiality criteria.

[*Name of CPA firm*]

Certified Public Accountants

[*City, State*]

[*Date*]

[*See notes to illustrative reports prepared under AICPA standards.*]

Example 7: Illustrative Trust Services Report on Management's Assertion Regarding the Effectiveness of Controls Related to the Privacy Principle

Independent Practitioner's Privacy Report

To the Management of ABC Company, Inc.:

We have examined ABC Company, Inc.'s (ABC Company) management assertion that, during the period [*month*] [*day*], 2009, through [*month*] [*day*], 2009, it:

Maintained effective controls over the privacy of personal information collected in its ______________ [*description of the entities and activities covered, for example "the mail-order catalog-sales operations"*] business (the Business) to provide reasonable assurance that the personal information was collected, used, retained, disclosed, and disposed of in conformity with its commitments in its privacy notice related to the Business and with criteria set forth in Generally Accepted Privacy Principles, issued by the American Institute of Certified Public Accountants (AICPA) and the Canadian Institute of Chartered Accountants, and

Complied with its commitments in its privacy notice, which is dated [*month*] [*day*], 2009, and [*is available at www.ABC-Company/privacy or accompanies this report*].

This assertion is the responsibility of ABC Company's management. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included (1) obtaining an understanding of ABC Company's controls over the privacy of personal information, (2) testing and evaluating the operating effectiveness of the controls, (3) testing compliance with ABC Company's commitments in its privacy notice, and (4) performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, ABC Company's management assertion that, during the period [*month*] [*day*], 2009, through [*month*] [*day*], 2009, ABC Company:

Maintained effective controls over the privacy of personal information collected in the Business to provide reasonable assurance that the personal information was collected, used, retained, disclosed and disposed of in conformity with its commitments in its privacy notice and with criteria set forth in Generally Accepted Privacy Principles; and

Complied with its commitments in its privacy notice referred to above,

is, in all material respects, fairly stated.

OR

In our opinion, ABC Company's management assertion referred to above is fairly stated, in all material respects, in conformity with ABC Company's privacy notice referred to above and with criteria set forth in Generally Accepted Privacy Principles.

Because of the nature and inherent limitations of controls, ABC Company's ability to meet the aforementioned criteria and the commitments in its privacy notice may be affected. For example, fraud, unauthorized access to systems and information, and failure to comply with internal and external policies or requirements may not be prevented or detected. Also, the projection of any conclusions, based on our findings, to future periods is subject to the risk that any changes or future events may alter the validity of such conclusions.

[*Name of CPA firm*]

Certified Public Accountants

[*City, State*]

[*Date*]

Comparison of SOC 1, SOC 2, and SOC 3 Reports

	SOC 1 Reports	*SOC 2 Reports*	*SOC 3 Reports*
Under what professional standard or interpretive guidance is the engagement performed?	Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) AICPA Guide *Service Organizations: Applying SSAE No. 16,*	AT section 101, *Attestation Engagements* (AICPA, *Professional Standards*) AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* (forthcoming)	AT section 101, *Attestation Engagements* (AICPA, *Professional Standards*) AICPA *Trust Services Principles Criteria and Illustrations* (AICPA, *Technical Practice Aids*)

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	SOC 1 Reports	*SOC 2 Reports*	*SOC 3 Reports*
	Reporting on Controls at a Service Organization (forthcoming)		
What is the subject matter of the engagement?	Controls at a service organization relevant to user entities internal control over financial reporting.	Controls at a service organization relevant to security, availability, processing integrity confidentiality, or privacy. If the report addresses the privacy principle, the service organization's compliance with the commitments in its statement of privacy practices.	Controls at a service organization relevant to security, availability, processing integrity, confidentiality, or privacy. If the report addresses the privacy principle, the service organization's compliance with the commitments in its statement of privacy practices.
What is the purpose of the report?	To provide information to the auditor of a user entity's financial statements about controls at a service organization that may be relevant to a user entity's internal control over financial reporting. It enables the user auditor to perform risk assessment procedures, and if a type 2 report is provided, to assess the risk of material misstatement of financial statement assertions affected by the service organization's processing.	To provide management of a service organization, user entities and other specified parties with information and a CPA's opinion about controls at the service organization relevant to security, availability, processing integrity, confidentiality, or privacy. A type 2 report that addresses the privacy principle also provides a CPA's opinion about the service organization's compliance with the commitments in its statement of privacy practices.	To provide interested parties with a CPA's opinion about controls at the service organization relevant to security, availability, processing integrity, confidentiality, or privacy. A report that addresses the privacy principle also provides a CPA's opinion about the service organization's compliance with the commitments in its privacy notice.

(continued)

	SOC 1 Reports	SOC 2 Reports	SOC 3 Reports
What are the components of the report?	A description of the service organization's system. A service auditor's report that contains an opinion on the fairness of the presentation of the description of the service organization's system, the suitability of the design of the controls, and in a type 2 report, the operating effectiveness of the controls. In a type 2 report, a description of the service auditor's tests of the controls and the results of the tests.	A description of the service organization's system. A service auditor's report that contains an opinion on the fairness of the presentation of the description of the service organization's system, the suitability of the design of the controls, and in a type 2 report, the operating effectiveness of the controls. If the report addresses the privacy principle, the service auditor's opinion on whether the service organization complied with the commitments in its statement of privacy practices. In a type 2 report, a description of the service auditor's tests of controls and the results of the tests. In a type 2 report that addresses the privacy principle, a description of the service auditor's tests of the service organization's compliance with the commitments in its statement of privacy practices and the results of those tests.	A description of the system and its boundaries[7] or in the case of a report that addresses the privacy principle, a copy of the service organization's privacy notice. A service auditor's report on whether the entity maintained effective controls over its system as it relates to the principle being reported on, such as, security, availability, processing integrity, confidentiality, or privacy, based on the applicable trust services criteria. If the report addresses the privacy principle the service auditor's opinion on whether the service organization complied with the commitments in its privacy notice.
Who are the intended users of the report?	Auditor's of the user entity's financial statements, management of the user entities, and management of the service organization.	Primary users generally are management of user entities. Other users may include parties that are knowledgeable about • the nature of the service provided by the service organization.	Any users who want assurance on controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy of a system, but do not have the need for the level of detail provided in a SOC 2 report. SOC 3 reports are general use reports, and can

[7] These descriptions are typically less detailed than the descriptions in a SOC 1 and SOC 2 report and are not covered by the practitioner's report.

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	SOC 1 Reports	*SOC 2 Reports*	*SOC 3 Reports*
		• how the service organization's system interacts with user entities, subservice organizations, and other parties. • internal control and its limitations. • the criteria and how controls address those criteria. • complementary user entity controls and how they interact with related controls at the service organization	be freely distributed or posted on a website as a seal.

Resource Central

.54 The following are various resources that practitioners and their clients.

New Online SOC Report Resources

.55 The AICPA has created a landing page on www.aicpa.org specifically for the new reporting options. Visit the following website for detailed information on service organization controls reports (formerly SAS 70 reports): www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/SOC/Pages/SORHome.aspx.

AICPA Online Professional Library: Accounting and Auditing Literature

.56 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC), the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB* Accounting Standards Codification™ subscription, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]).To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.57 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *Annual Update for Accountants and Auditors (2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVDE]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.

.58 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.59 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.60 To register or learn more, visit www.cpa2biz.com.

Webcasts

.61 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.62 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.63 Do you have a complex technical question about generally accepted auditing standards, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.64 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

The Center for Audit Quality

.65 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and

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aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.66 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit www.aicpa.org/InterestAreas/CenterForAuditQuality/Pages/CAQHome.aspx.

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee)	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company	Information on the initiative to	www.pcfr.org

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Website Name	*Content*	*Website*
Financial Reporting Committee	further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov

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AAM Section 8090

Real Estate and Construction Industry Developments—2010/11

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Real Estate and Construction Industry Developments—2009*.

This Audit Risk Alert is intended to provide auditors of financial statements of real estate and construction entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully appreciates the invaluable assistance Dave Arman provided in creating this publication.

The AICPA gratefully acknowledges Christopher Roemersma of Beers & Cutler PLLC for his essential contributions in creating this publication.

Feedback

The Audit Risk Alert *Real Estate and Construction Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your real estate and construction industry audits and also can be used by an entity's internal management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) explains important issues that affect all entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

The Current Economy

.03 When planning and performing audit engagements of real estate ventures and construction contractors, an auditor should understand both the general current economy and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

.04 The year 2010 may be the beginning of a wave of global economic recovery. Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. Further, after experiencing a considerable decline in the stock market through March 2009, the markets have rebounded substantially. In March 2009, the S&P 500 and the Dow Jones Industrial Average reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002. By March 2010, only a year later, all 3 had increased in value by at least 59 percent from the previous year's lows. However, all 3 remained unmoved 4 months later, in July 2010. This exhibits the continuing uncertainty in the markets due to the varying economic indicators, the financial reform regulatory changes, and Europe's economy, among other reasons.

Key Economic Indicators

.05 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.06 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 2.7 percent in the first quarter of 2010 (third estimate) and 5.6 percent in the fourth quarter of 2009. This data indicates a turnaround in the economy because in the fourth quarter of 2008 and the first quarter of 2009, real GDP decreased 6.3 percent and 5.5 percent, respectively. Further, in June 2010, the Treasury reported that banks had repaid about 75 percent of the bailout money they received through the Troubled Asset Relief Program, and that taxpayers made $21 billion on the investment. However, other bailouts are not yet repaid, and they may yield losses to taxpayers.

.07 From June 2009 to June 2010, the unemployment rate fluctuated between 9.4 percent and 10.1 percent. An unemployment rate of 10.0 percent represents approximately 15.3 million people. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. However, during 2010, the rate has remained below 10.0 percent. Additionally, 1 reason for the continued high unemployment rate is that more Americans are resuming their search for work.

.08 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent, where it remained through June 2010. The Federal Reserve described the current economic recovery in its June 23, 2010, press release as follows:

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- Household spending is increasing but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software has risen significantly; however, investment in nonresidential structures continues to be weak, and employers remain reluctant to add to payrolls.
- Housing starts remain at a depressed level.
- Financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad.
- Bank lending has continued to contract in recent months.

.09 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period."

.10 According to preliminary statistics dated as of May 2010 from the Bureau of Economic Analysis, the real estate and rental and leasing industry comprised 12.8 and 13.0 percent of the country's GDP in both 2008 and 2009, respectively. The construction industry accounted for 4.1 percent of the country's GDP in 2008 and declined to 4.1 percent in 2009. Although preliminary, these advance statistics provide reliable information on the direction of change in real growth and an indication of whether a particular industry's real growth was well above, well below, or about average with respect to overall GDP growth.

.11 As of May 2009, the real estate and construction industries in the United States employ approximately 9.6 million people, up from 9.2 million as of September 2008, according to the Bureau of Labor Statistics. This figure comprises 2.1 million in the real estate industry and 7.5 million in the construction industry.

Real Estate Market Conditions

Residential Real Estate Market Conditions

.12 The residential real estate market has been experiencing a slow recovery, but continues to show signs of improvement. According to the National Association of Realtors (NAR), the Pending Home Sales Index,[1] a forward-looking indicator based on contracts signed in June 2010, fell to 75.7 (down 2.6 percent from a reading of 77.7 in May 2010), and is 18.6 percent below June 2009, when it was 93.0 percent. The NAR believes that much of this uptick was related to the American Recovery and Reinvestment Act of 2009 (ARRA), which expanded the first-time home buyer credit, created by the Housing and Economic Recovery Act of 2008, by increasing the credit amount to $8,000 for purchases made before December 1, 2009. Subsequently, the Worker, Homeownership and Business Assistance Act of 2009 extended the deadline to cover taxpayers who had a binding contract to purchase a home before May 1, 2010, and closed on the home prior to July 1, 2010. NAR Chief Economist Lawrence Yun noted, "The home buyer tax credit brought close to 1 million additional buyers into the market, which is now helping the trade-up market and has significantly improved the inventory situation. This stabilized home prices more quickly and has preserved about $900 billion in home equity; in turn, that is keeping additional households from going underwater and risking foreclosure."

.13 According to the NAR, the seasonally adjusted annualized rate of existing home sales decreased 5.1 percent to 5.37 million units in June 2010, but are 9.8 percent higher than the 4.89 million-unit pace of June 2009. Although this improvement is a positive sign, Yun cautioned that the market shows uncharacteristic yet understandable swings as buyers respond to the tax credits.

.14 Total housing inventory at the end of June 2010 rose 2.5 percent to 3.99 million existing homes available for sale. The figure represents an 8.9-month supply at the current sales pace, up from an 8.3-month supply in May 2010. Raw inventory remains 12.7 percent below the record of 4.58 million in July 2008.

[1] The Pending Home Sales Index is a leading indicator for the housing sector and is based on pending sales of existing homes. A sale is listed as "pending" when the contract has been signed but the transaction has not closed, though the sale usually is finalized within 1 or 2 months of signing. The National Association of Realtors notes that an index of 100 is equal to the average level of contract activity during 2001, which was the first year to be examined, as well as the first of 5 consecutive record years for existing home sales.

.15 In June 2010, the national median existing home price was $183,700. This represents an increase of 1.0 percent from June 2009. These figures include distressed sales (which normally depress the median price) of 32 percent of the total for June 2010, an improvement of 1 percent over May 2010.

.16 In contrast with the NAR's figures, the 20-city slice of the S&P/Case-Shiller Home Price Index recorded a decrease of 3.2 percent in the first quarter of 2010, although the index remains above its first quarter 2009 level. The NAR's existing home price levels are calculated on a monthly basis, whereas the S&P/Case-Shiller Index is calculated using a 3-month rolling average, which affects the comparability of the 2 measures. According to the S&P/Case-Shiller Home Price Index, housing prices have rebounded from crisis lows, but recently have seen renewed weakness as tax incentives are ending and foreclosures are climbing. Further, according to David M. Blitzer, chairman of the Index Committee at Standard & Poor's, "While year-over-year results for the National Composite, 18 of the 20 MSAs (metro areas) and the two Composites (10-City and 20-City), the most recent monthly data are not as encouraging." He continued by saying, "It is especially disappointing that the improvement we saw in sales and starts in March did not find its way to home prices. Now that the tax incentive ended on April 30, we don't expect to see a boost in relative demand."

.17 Consequently, as another possible sign of improvement, the Federal Open Market Committee (FMOC) was nearly silent regarding the housing market during its August 2010 meeting, in contrast with its scheduled meetings in the latter part of 2009. The remarks that were made were tempered as well. During its April 2010 meeting, the FMOC noted that starts of new single-family homes edged up over February and March 2010, but much of this increase likely reflected delayed projects getting under way as weather conditions returned to normal. Although sales of new single-family homes did increase, along with sales of existing single-family homes, the boost was likely caused by the expiration of the home buyer tax credit. In June 2010, the FMOC noted that housing starts dropped in May 2010, and nonresidential construction remained depressed.

.18 In remarks before the Committee on the Budget of the U.S. House of Representatives on June 9, 2010, Chairman of the Federal Reserve Ben Bernanke noted that "In the housing market, sales and construction have been temporarily boosted lately by the home buyer tax credit. But looking through these temporary movements, underlying housing activity appears to have firmed only a little since mid-2009, with activity being weighed down, in part, by a large inventory of distressed or vacant existing houses and by the difficulties of many builders in obtaining credit."

.19 According to a statement released by the Commerce Department on August 17, 2010, U.S. housing starts were positive in July 2010, rising 1.7 percent to a seasonally adjusted annual rate of 546,000, although representing a 7.0 percent decrease from July 2009. Single family housing starts fell 4.2 percent to 432,000. Although starts were mixed, building permits declined by 3.1 percent in July 2010, to a seasonally adjusted annual rate of 565,000, and showed a 3.7 percent decrease over July 2009. Permits for single family homes fell slightly as well, down 1.2 percent.

.20 According to RealtyTrac, foreclosure filings were reported on 325,229 properties in July 2010, a 4 percent increase from June 2010, but a 10 percent increase from July 2009. According to James Saccacio, CEO of RealtyTrac, "July marked the 17th consecutive month with a foreclosure activity total exceeding 300,000. Declines in new default notices, which were down on a year-over-year basis for the sixth straight month in July, have been offset by near-record levels of bank repossessions, which increased on a year-over-year basis for the eighth straight month."

.21 Due to the overwhelming pressures of the economy as a whole, many borrowers are finding themselves "underwater" with respect to their home mortgages. This underwater condition is forcing many homeowners to consider options such as loan modification or short sales or, as a last resort, foreclosure. Attitudes towards foreclosure are changing, however. A new online survey conducted May 10–12, 2010, by Harris Interactive showed a notable decrease in consumers' willingness to buy foreclosed properties compared to 1 year ago. Further, only 1 percent of homeowners with a mortgage say walking away from their home would be their first choice if they were unable to pay their mortgage. If their mortgage were to go underwater, 41 percent would at least consider walking away, whereas 59 percent would not consider walking away no matter how

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much their mortgage was underwater. This is a reversal of sentiment when compared to the same period 1 year ago.

.22 With all of the various data available, most experts believe the residential market may have hit a definite bottom; general sentiment is that it will come back and regain the confidence of investors as a strong investment vehicle over time.

Rental Real Estate Market Conditions

.23 The apartment rental market—multifamily housing—is expected to benefit from a slowly improving economy and job market. Multifamily vacancy rates are forecast to decline from 7.3 percent in the first quarter of this year to 6.3 percent in the first quarter of 2011.

.24 With recent additions to supply, average rent is likely to slip 1.5 percent this year, and then rise 1.2 percent in 2011. Multifamily net absorption should be 145,700 units in 59 tracked metro areas this year and another 214,500 in 2011.

.25 According to CB Richard Ellis (CBRE), demand for U.S. rental apartments remains weak amid sharp job losses, and a glut of vacant single family homes and condominiums for sale and for rent still exists. Further, apartment rents and revenues continue to be negatively affected by high unemployment.

Office Real Estate Market Conditions

.26 With an elevated level of sublease space available, vacancy rates in the office sector are projected to increase from 16.9 percent in the first quarter of this year to 17.6 percent in the first quarter of 2011, but should ease later next year.

.27 Annual office rent is likely to fall 2.3 percent this year and decline another 2.1 percent in 2011. In 57 markets tracked, net absorption of office space, which includes the leasing of new space coming on the market as well as space in existing properties, is forecast to be a negative 24.6 million square feet this year and then a positive 25.5 million in 2011.

Industrial Real Estate Market Conditions

.28 Leasing activity in the industrial sector is below historical levels with higher vacancies, more tenant concessions from landlords, and a steeper decline in rental rates. In addition, obsolete structures remain on the market. Industrial vacancy rates are expected to rise from 14.3 percent in the first quarter of 2010 to 14.8 percent in the first quarter of 2011, then decline modestly as the year progresses.

.29 Annual industrial rent will probably drop 6.3 percent this year and decline another 1.5 percent in 2011. Net absorption of industrial space in 58 markets tracked is seen at a negative 90.0 million square feet this year and a positive 135.6 million in 2011.

Retail Real Estate Market Conditions

.30 The economic slowdown, increased unemployment, and volatility of gas prices have left consumers with less disposable income; therefore, they have been curtailing their retail spending. The labor market also continues to erode consumer spending. As a result of continued high unemployment, potential consumers are spending less time making retail purchases and more time searching for jobs. As a lagging indicator of economic performance, the high unemployment figures are projected to remain that way for some time.

.31 Retailers are facing the challenge of not only decreased sales in a weak economy but a credit market that remains challenged, with limited capital available for reorganization. Because of this, Chapter 11 reorganizations in recent months have become little more than a delaying action before total liquidation. Most

chains will continue the trend of shuttering underperforming locations that began at the start of the current economic crisis.

.32 Retail vacancy rates should rise modestly from 12.6 percent in the first quarter of this year to 12.8 percent in the first quarter of 2011, and should hold at that level for most of next year.

.33 Average retail rent is projected to decline 1.5 percent in 2010, then edge up by 0.4 percent next year. Net absorption of retail space in 53 tracked markets is likely to be a negative 3.7 million square feet this year and then a positive 8.9 million in 2011.

.34 Although the short-term outlook remains grim, according to a recent survey conducted by CBRE, nearly 70 percent of U.S. retailers believe that the overall economy is improving, and 92 percent are planning to increase store openings. The survey also found that although retailers believe the economy is improving, nearly 60 percent think that it will take another 6–18 months before their segment of the retail market feels the benefit of the recovery.

Hospitality Real Estate Market Conditions

.35 Data released for mid-May 2010 from Smith Travel Research presents the key statistics of North America's hospitality market's overall health. Year-to-date key industry measures show occupancy up 19.1 percent at 61.3 percent, the average daily rate increased 4.3 percent at $97.21, and revenue per available room rose 24.2 percent at $59.56 when compared with year-to-date May 2009. Although the recent trends are positive, the hospitality market occupancy, rates, and revenues all continue to be deeply depressed. Also according to Smith Travel Research, 2010 will end without much improvement, noting metrics of 56.7 percent, $97.26, and $55.13 for occupancy, rates, and revenue, respectively.

Real Estate Investment Trust Market Conditions

.36 Interest and investment in real estate investment trusts (REITs) has increased dramatically from the creation of REITs in 1960, and especially over the last 10 years. According to the National Association of Real Estate Investment Trusts (NAREIT), average daily dollar trading volume has significantly increased from roughly $100 million in 1994 to more than $4.9 billion today. As a result of their liquidity, REITs and listed real estate equities have become the most efficient way for investors and investment managers across the globe to gain exposure to commercial real estate; an effective way for professional investment managers to manage their investment exposure to real estate; and a meaningful way to reduce the risk of illiquidity.

.37 According to NARIET, REIT shares continued their strong performance in the first 3 months of 2010, nearly doubling the performance of the S&P 500 in the quarter and doubling their own values on a 1-year basis at the quarter's end. In the first quarter, the Financial Times Stock Exchange (FTSE) NAREIT All REITs Index delivered a total return of 9.57 percent, and the FTSE NAREIT Equity REITs Index returned 10.02 percent, compared with the 5.39 percent return of the S&P 500. On a 1-year basis through March 31, the FTSE NAREIT All REITs Index returned 98.88 percent, and the FTSE NAREIT Equity REITs Index gained 106.68 percent. By comparison, the total return of the S&P 500 was 49.77 percent.

.38 "REITs continue to benefit from their recapitalization over the past year, in which they raised more than $35 billion in equity and debt offerings in the public markets," said NAREIT President and CEO Steven Wechsler. "The new capital enabled them to pay down or refinance near-term debt and position themselves as winners in a marketplace in which many commercial real estate owners face significant debt maturities without access to the capital needed to meet these obligations."

Securitization Market Conditions

.39 Another market greatly affected by the residential real estate downturn is the securitization market. Remarks by Federal Reserve Chairman Ben Bernanke, delivered in late 2009 regarding the "frozen" state of

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the securitizations market, continue to be relevant. Further, the overall economic conditions are contributing to the damage to the overall health of the securitization market's largest players.

.40 The biggest market makers of mortgage backed securities are the Federal Home Loan Mortgage Corp (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae), both of which have implicit government backing. As of 2008, Fannie Mae and Freddie Mac owned or guaranteed about half of the United States' $12 trillion mortgage market. This made both corporations highly susceptible to the recent subprime mortgage crisis. Ultimately, in July 2008, the U.S. government took action to prevent the collapse of both corporations. The Treasury Department and the Federal Reserve took several steps to bolster confidence in the corporations, including extending credit limits, granting both corporations access to Federal Reserve low-interest loans (at similar rates as commercial banks), and potentially allowing the Treasury Department to own stock. This event also renewed calls for stronger regulation of government-sponsored enterprises (GSEs) by the government.

.41 On September 7, 2008, the director of the Federal Housing Finance Agency (FHFA), James B. Lockhart III, announced his decision to place the two GSEs into conservatorship run by the FHFA, which continues today.

.42 On June 16, 2010, both GSEs' stocks were delisted from the New York Stock Exchange for failing to maintain a minimum stock price.

.43 Today, Fannie Mae and Freddie Mac own or guarantee 53 percent of the United States' $10.7 trillion mortgage market, according to the Federal Reserve.

Construction Market Conditions

.44 The construction industry continues to be strongly affected by the real estate market's slowdown and slow recovery, and its negative effects are projected to continue through 2010. In addition to the continuing struggles of the real estate market, the construction industry must also face rising energy and material costs, which experts estimate will only continue to rise.

.45 Further, several additional factors are weighing on the construction market. Although the municipal bond market has become more active in 2010, the available pool of bank financing continues to be small. State and local spending continues to be narrow, and the overall lack of job growth and enormous unemployment (both of which some studies are showing at a 25 percent level) is adding to the depressed state of the market.

.46 According to the Associated General Contractors of America's (AGC's) Chief Economist Ken Simonson, "Aside from temporary stimulus projects and a fragile housing market, demand for new construction remains depressed for the foreseeable future. As a result, construction employment won't return to pre-downturn levels for many months."

Construction Put in Place

.47 Construction put in place is one of the nation's key economic indicators as reported by the U.S. Census Bureau and represents the value of construction installed or erected at a construction site during any given period. This includes the cost of materials and labor, the contractor's profit, costs of architects and engineers, overhead, and all interest and taxes paid.

.48 According to the U.S. Census Bureau, in a June 1, 2010, release, construction spending during April 2010 was estimated at a seasonally adjusted annual rate of $869.1 billion compared to $971.4 billion estimated for April 2009. Further, during the first 4 months of 2010, construction spending amounted to $249.6 billion, 13.2 percent below the $287.5 billion for the same period in 2009.

.49 Total residential construction, both private and public, although only comprising approximately 37.3 percent of total construction spending, has seen relatively flat spending. The seasonally adjusted annual rate

of residential construction as of April 2010 was $535.2 billion compared to $513.0 billion as of April 2010, an increase of nearly 4.2 percent.

Public and Private Construction

.50 Both public and private construction sectors are in a year-over-year decline, down 4.4 percent and 13.5 percent, respectively. The only areas with an increase in value are private residential construction (4.1 percent) and public projects dedicated to conservation and development (10.7 percent). Although the private residential sector is large enough to move the overall construction economy, conservation and development are less than 1 percent of the overall pool, contributing little to the bottom line.

Residential Construction

.51 In June 2010, the U.S. Census reported the following seasonally adjusted annual statistics from May 2009 to May 2010 for new privately owned residential construction:

- 4.4 percent increase in new privately owned housing units authorized by permits
- 7.8 percent increase in new privately owned housing units started
- 15.4 percent decrease in new privately owned housing units completed

.52 The housing starts and permits granted are an encouraging sign, although both are below their April 2010 rates. The decrease in completions reflects a lag from the depressed recent levels of permits and starts, and fewer units have been started and, thus, less completed. According to the NAR, total housing inventory at the end of April 2010 rose 11.5 percent to 4.04 million existing homes available for sale, which represents an 8.4-month supply at the current sales pace, up from an 8.1-month supply in March 2010.

Construction Cost Trends

.53 According to research by the AGC, prices increased significantly for a range of construction components. Compared to March 2010, the April 2010 data shows that diesel fuel was up 6.5 percent (not seasonally adjusted); steel mill products were up 5.2 percent; lumber and plywood were up 4.7 percent; copper and brass mill shapes were up 4.3 percent; aluminum mill shapes were up 3.6 percent; and gypsum products were up 2.4 percent. Over the past year, increases in materials costs by structure type have ranged from 3.9 percent for single-unit residential construction to 8.3 percent for inputs to highway and street construction.

.54 In an August 17, 2010, announcement, the Bureau of Labor Statistics noted that the Producer Price Index for finished goods, intermediate goods, and crude goods all held nearly steady in July at a rate of 0.3, (0.4), and 2.7 percent, respectively. These figures represent a monthly change, whereas the year-over-year changes are more dramatic. Finished goods rose 5.3 percent in the last 12 months, whereas intermediate and crude goods rose 8.5 and 21.2 percent, respectively. With lumber being classified as an intermediate good, and crude goods including iron and steel, the increases in these 2 categories continues to be a drag on the industry.

Going Green

.55 As demands for social responsibility continue to evolve, so does the increase in construction of environmentally friendly, or green, buildings. According to the U.S. Green Building Council, buildings are responsible for 38 percent of carbon dioxide emissions, 72 percent of electricity consumption, 39 percent of energy use, 14 percent of water consumption, and 30 percent of nonindustrial waste. This explains the strong push to make them green.

.56 Other contributing factors to the current and projected increase of green buildings include regulatory mandates, government incentives, and recent studies proving the valuable rewards to be gained. This surge in growth has necessitated the emergence of the Leadership in Energy and Environmental Design (LEED) Green Building Rating System. LEED is a third party certification that designates a building as environmentally responsible, profitable, and a healthy place to live and work. According to Rosenberg Real Estate Equity

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Funds (RREEF), a business of Deutsche Bank's Asset Management Division, many cities are even beginning to include LEED standards in their building codes. Further, the RREEF found that lower energy costs could translate into as much as $135,000 in annual savings for a 200,000 square foot building. In addition, LEED-certified Class A office building rentals cost an average of $10 per square foot more than those that are not certified but only have a vacancy rate of 7.4 percent, which is significantly lower than noncertified properties.

.57 According to the U.S. General Services Administration, green buildings show the following:

- 26 percent less energy use
- 13 percent lower overall maintenance costs
- 27 percent higher occupant satisfaction
- 33 percent less CO2 emissions

.58 Additional studies show design features of green buildings promote happier, more productive, and healthier workers. This type of data has and will continue to create demand for green buildings.

.59 According to the RREEF, the premium for constructing a green building as opposed to a traditional building is nominal if planned properly. Additionally, the numerous incentives for building green more than offset any increase in building costs. Renovating traditional buildings to be green is not as straightforward regarding the net benefit, given the diversity of characteristics of existing buildings.

.60 In May 2010, the first commercial skyscraper to earn Platinum certification under the U.S. Green Building Council's LEED Core & Shell rating system was officially opened. Located in New York City, the building's design makes it environmentally friendly, using technologies such as floor-to-ceiling insulating glass to contain heat and maximize natural light, and an automatic daylight dimming system to reduce energy use. The tower also features a water recycling system, which captures rainwater and reuses it.

Legislative and Regulatory Developments

Government Intervention

Real Estate

.61 In the past several years, the federal government has taken extraordinary steps to stabilize the housing market and get the economy back on track. Early efforts focused on encouraging lenders, counselors, and borrowers to voluntarily work out subprime loans heading for foreclosure. Although these early programs helped millions of distressed homeowners, they failed to stem the rise of loan delinquencies and foreclosures. Consequently, the Obama administration launched a far more ambitious plan to help as many as 3–4 million homeowners reduce their mortgage payments to 31 percent of their incomes by using a combination of carrots and sticks for lenders.

.62 Recognizing that rising unemployment rates and other factors would mean increases in the number of distressed properties, the federal government provided additional funding in 2008 and 2009 to help state and local governments deal with foreclosed homes. With the help of the Neighborhood Stabilization Program and an additional $11 billion in housing bond authority, state and local entities developed, and continue to develop, strategies to acquire, renovate, and sell foreclosed 1- to 4-unit properties. Although modest in relation to the size of the problem, these resources could be instrumental in helping to stabilize neighborhoods where foreclosures are concentrated.

.63 The federal government also provided funds to redevelop public housing, a tax credit of up to $8,000 for first time home buyers, and an opportunity for homeowners who were up to 5 percent "underwater" on their mortgages to refinance at lower interest rates. Other efforts to keep mortgage credit flowing and reduce its cost include buying Freddie Mac and Fannie Mae mortgage backed and debt securities, providing equity

injections to financial institutions, and developing a plan to buy troubled loan assets from banks. Although current initiatives to bolster financial institutions and prevent foreclosures eclipse any previous attempts to stabilize housing markets, the federal tax credit (in real terms) and interest rate reduction are still less generous than the stimulus used to jolt the housing market back to life in 1974.

.64 Finally, the federal government took a number of steps to address the falling prices for low income housing tax credits (LIHTCs). These measures are important because LIHTCs are the principal program for preserving and building low income rental housing. At a time when millions of families are being forced out of home ownership, when many others are choosing to rent, and when demographic forces are set to drive up rental demand, expanding the supply of such housing is critical.

.65 In early 2009, President Obama announced the Making Home Affordable (MHA) program, which was designed to help up to 7–9 million families avoid foreclosure by restructuring or refinancing their mortgages. In doing so, the plan attempted to aid homeowners behind on their payments or at risk of defaulting and homeowners with mortgages that exceeded the value of their property. The plan also attempted to prevent neighborhoods and communities from being pulled over the edge as defaults and foreclosures contributed to falling home values, failing local businesses, and lost jobs. The MHA program was designed to offer assistance with an initial $75 billion Homeowner Stability Initiative. This initiative was designed to bring qualifying existing mortgages to "above water" status, reduce the existing interest rates and payment amounts, and protect against further home price declines. These modifications would be designed and implemented by the lender, with homeowner approval. For cases of homeowner insolvency and bankruptcy cases, the presiding bankruptcy judge would be given additional authority to modify existing mortgages.

.66 In May 2009, President Obama signed into law the Helping Families Save Their Homes Act. The act expanded and improved the Federal Housing Administration's (FHA's) HOPE for Homeowners program, which included various counseling and foreclosure prevention programs to provide access and assistance to more people. The act provided incentives for servicers and lenders to expand access to the HOPE for Homeowners program. In addition, it allowed the government, through the FHA and the Rural Housing Service, to modify loan terms in order to help a homeowner avoid foreclosure. Funding also was provided for foreclosure prevention and counseling.

.67 In mid-June 2009, President Obama introduced the government's plan for reforming financial oversight in an effort to stem a repeat of the current financial crisis. One tenant of the reform package took aim at the perceived recklessness of the lending practices surrounding the mortgage market, which were seen as a direct cause of the collapse of the housing market and the nationwide epidemic of home foreclosures.

.68 Due to the practice of securitization, mortgage originators have had little incentive to ensure that the mortgages they were entering into had a high likelihood to be repaid. As the originators would securitize the mortgages and sell them off their books, any defaults would be absorbed by the investor rather than the originator. The president's plan called for the retention of a portion of the original risk.

.69 Further, the Credit Risk Retention Act of 2009 amends "the Truth in Lending Act to require any creditor who transfers, sells, or conveys certain residential mortgage loans to third parties to retain an economic interest in a material portion of the credit risk for any such loan, and for other purposes." This act also "require[s] creditors to retain at least 5 percent of the credit risk on any nonqualified mortgage that is transferred, sold or conveyed." This restriction, in theory, forces originators and lenders to be more cautious in their lending practices because they retain a portion of the risk, even when they ultimately securitize the loan.

.70 In late 2008, the Federal Reserve announced the creation of the Term Asset-Backed Securities Loan Facility (TALF). The Federal Reserve Bank of New York will lend up to $200 billion to holders of certain AAA-rated asset backed securities (ABSs) backed by newly and recently originated consumer and small business loans through December 31, 2009. The intent of this facility is to increase credit availability for student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration (SBA). (The Treasury Department announced plans to purchase up to $15 million in securities backed by SBA loans.)

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.71 In March 2009, the Federal Reserve Board announced that the eligible collateral for loans extended by TALF was expanded to include ABSs backed by mortgage servicing advances, loans or leases related to business equipment, leases of vehicle fleets, and floorplan loans. Two months later, in May 2009, the maturities of TALF loans were extended to five years (from three years), and eligible collateral under TALF was expanded further to include commercial mortgage-backed securities (CMBSs) and securities backed by insurance premium finance loans. Certain CMBSs issued prior to January 1, 2009 (legacy CMBSs), in addition to newly and recently issued CMBSs, are eligible collateral under TALF.

.72 During the economic crisis, the issuance of CMBSs halted, which further weakened the economy. The inclusion of newly and recently issued CMBSs will ideally stimulate commercial lending, which may prevent defaults on current commercial property loans, increase the capacity of current holders of maturing mortgages to make additional loans, and facilitate the sales of distressed properties. The inclusion of certain legacy CMBSs is intended to promote price discovery and liquidity for legacy CMBSs. The goal of the improvements to the legacy CMBSs markets is to promote new issuances of CMBSs, which helps borrowers purchase commercial properties or helps a current owner of a commercial property refinance on better terms. Overall, the commercial real estate market is still relatively unstable, which may ease with the recent changes to TALF.

.73 On August 17, 2009, the Federal Reserve and the Treasury approved extending TALF loans against newly issued ABSs and legacy CMBSs through March 31, 2010, and approved TALF lending against newly issued CMBSs through June 30, 2010. The Federal Reserve will continue to monitor financial conditions and will consider whether circumstances warrant a further extension.

.74 Currently, the Restoring American Financial Stability Act of 2010, proposed by U.S. Senate Banking Committee Chairman Christopher Dodd, is being debated in Congress. Among other provisions, the act is designed to create stronger consumer protections, including protections related to consumer mortgages and rules governing the behavior of the companies that offer them. These protections focus on making mortgage products more transparent by increasing the availability of relevant information. Further, the reform is designed to ban abusive practices in the mortgage markets, for example, requiring mortgage brokers and banks to consider a family's ability to repay when making a loan. The reforms also will require lenders and Wall Street loan packagers to retain a portion of the risk when selling off loans to investors, similar to the provisions of the Credit Risk Retention Act of 2009, and make full disclosure so investors know what's in those packages. Lastly, reforms of credit rating agencies will help make sure investors do not rely unwisely on their ratings on these packages.

Construction

.75 In addition to state and local ordinances (for example, building codes and zoning restrictions), construction contractors are subject to significant federal oversight. Regulatory bodies, such as the Environmental Protection Agency, the Occupational Safety and Health Administration, and the Equal Employment Opportunity Commission, impose numerous restrictions on construction contractors. Although they have an effect on the operating activities of construction contractors, such restrictions generally do not affect their financial statement reporting.

.76 ARRA has granted a 1-year delay, until January 1, 2012, of a new law that will require federal, state, and local governments to withhold 3 percent from all payments for goods and services as a guard against possible business tax evasion. This far-reaching new requirement was inserted as a last minute revenue raiser into the Tax Increase Prevention and Reconciliation Act of 2005 that was signed by President Bush in May 2006, and this requirement also will affect other industries. The law applies to all government payments for products and services made by any federal, state, or local government that has total annual contracts of at least $100 million. A number of construction-related organizations are working to have this section of the act repealed.

.77 A key consideration of the repeal contingency is that the 3 percent withholding tax would be on the total contract versus the true taxable income at the end of the construction project, which is only the profit. This essentially creates a cash flow timing issue that could result in cash flow deficiencies when the

construction company pays the government too much in tax upfront and receives it back from the government months later. This is problematic given the nominal margins in the construction industry, which rarely meet or exceed 3 percent, according to the AGC.

.78 For example, if a small business contractor holds 1 government contract estimated to be completed in 1 year for $10 million, this law requires withholding $300,000 on that contract. Meanwhile, the contractor expects to net approximately 2.5 percent, or $250,000, after paying for supplies, services, subcontractors, and other ordinary business expenses. The tax on the revenue generated is, at most, 35 percent, which means the maximum tax owed on the $10 million project is $87,500 (35 percent of $250,000). Ultimately, the government has withheld $300,000 for $87,500 in tax liability.

.79 ARRA also created the new Build America Bond program, which authorizes state and local governments to issue Build America Bonds as taxable bonds in 2009 and 2010 to finance any capital expenditures for which they otherwise could issue tax exempt governmental bonds. State and local governments receive a direct federal subsidy payment for a portion of their borrowing costs on Build America Bonds equal to 35 percent of the total coupon interest paid to investors.

.80 ARRA further created a new category of municipal bonds called Recovery Zone Bonds that are broken into two types: Recovery Zone Economic Development Bonds (RZEDBs) and Recovery Zone Facility Bonds (RZFBs). ARRA earmarked $10 billion of RZEDBs, which are governmental bonds to be used for governmental purposes that will allow a county or large municipality to borrow on a lower cost than traditional tax exempt financing. RZEDBs may be issued for purposes of promoting development or other economic activity, including public infrastructure and construction of public facilities or job training and educational facilities, in an area that has been designated by the county or municipality as a recovery zone.[2] RZEBDs are taxable; however, the federal government would reimburse the county or municipality for 45 percent of the interest paid, making the true cost of the interest paid lower than that paid on tax exempt bonds. ARRA earmarked $15 billion of RZFBs. RZFBs permit counties and large municipalities to provide tax exempt financing for projects that historically would not qualify (for example, large manufacturing plants, distribution centers, hotels, research parks, and so on). RZFBs are private activity bonds and are classified as exempt facility bonds for tax purposes. ARRA provides that Recovery Zone Bonds may only be issued until December 31, 2010.

.81 ARRA also has a provision creating enhanced net operating loss (NOL) carryback provisions. Under those provisions, eligible small businesses may carry back a 2008 NOL up to 5 years instead of the otherwise available 2-year limit. Eligible small businesses are those with average gross receipts of $15 million or less for the 3-year period ending in 2008. This provision may have a significant impact on builders and construction contractors in the current year.

Health Care Reform

.82 In March 2010, the president signed into law a sweeping overhaul of the health care system. Almost everyone in the United States will be affected by these changes—individuals, insurance companies, health care providers, and employers. The three primary goals of the reform are to expand coverage to those without health insurance, reform the delivery system of benefits to improve quality, and decrease the costs of providing health care. The various provisions of the reform will become effective over time, through 2020. The new laws contain many changes for employers to consider for financial reporting purposes, in addition to many new tax rules to help offset the overall cost of the reform.

.83 The complete changes are contained in two acts. The Health Care and Education Reconciliation Act of 2010 was signed on March 30 and is a reconciliation bill that amends the Patient Protection and Affordable Care Act signed into law by the president one week earlier. In April, the Securities and Exchange Commission (SEC) issued a staff announcement, *Accounting for the Health Care and Education Reconciliation Act of 2010 and the Patient Protection and Affordable Care Act*, to address questions that have arisen about the effect, if any, that the different signing dates might have on accounting for the two acts. This timing difference, related solely

[2] A *recovery zone* is any area that has been designated by the county or a large municipality as having significant poverty, unemployment, home foreclosures, or general distress; any area affected by military realignment; or any area that has been designated as an empowerment zone or a renewal community.

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to the signing dates, should not have an impact on a majority of registrants because the acts were both signed within a relatively short time period, which for the vast majority of entities, falls into the same reporting period. However, there may be a limited number of registrants with a period-end that falls between the signing dates for which the timing difference could raise questions about whether the different signing dates have an accounting impact.

.84 After consultation with the Financial Accounting Standards Board (FASB) staff, the Office of the Chief Accountant would not object to a view that the two acts should be considered together for accounting purposes. That is, in this specific fact pattern, the SEC staff would not object to a registrant incorporating the effects of the Health Care and Education Reconciliation Act of 2010 when accounting for the Patient Protection and Affordable Care Act. This view is based in part on the SEC staff's understanding that the two acts, when taken together, represent the current health care reform as passed by Congress and signed by the president. The SEC staff does not believe that it would be appropriate to analogize to this view in any other fact patterns.

Significant Accounting and Tax Considerations

.85 FASB *Accounting Standards Codification* (ASC) 740-10-30-2 states that the following basic requirements are applied to the measurement of current and deferred income taxes at the date of the financial statements:

- The measurement of current and deferred tax liabilities and assets is based on provisions of the enacted tax law; the effects of future changes in tax laws or rates are not anticipated.
- The measurement of deferred tax assets is reduced, if necessary, by the amount of any tax benefits that, based on available evidence, are not expected to be realized.

.86 FASB ASC 715-60-35-102 further explains that benefit coverage for medical claims by governmental programs or other providers of health care benefits should be assumed to continue as provided by the present law and other providers, pursuant to their present plans. Consistent with FASB ASC guidance, presently enacted changes in the law or amendments of the plans of other health care providers that take effect in future periods and that will affect the future level of their benefit coverage should be considered in current period measurements for benefits expected to be provided in those future periods. Future changes in laws concerning medical costs covered by governmental programs and future changes in the plans of other providers should not be anticipated.

.87 The two primary accounting considerations resulting from this reform are the effects of the tax law changes on deferred income tax balances and other postretirement health benefits. One of the most significant changes relates to the government subsidy for providing qualifying prescription drug coverage to Medicare-eligible retirees becoming an offset for prescription drug income tax deductions. Specifically, because entities will need to reduce their income tax deduction for providing prescription drug coverage by the subsidy received, they currently need to record a charge to earnings to write off a portion of their deferred tax assets related to postretirement health care obligations. Such deferred tax assets were based on the gross liability amount. Because the tax deductible prescription drug costs liability will be reduced by the subsidy, the deferred tax asset will be computed net of the subsidy, resulting in a lower deferred tax asset. The federal subsidy will not reduce the tax deductions until 2013. Even though the changes may not be effective until future periods, the effects are accounted for in the period that includes the enactment date. FASB ASC 715-60 discusses accounting and reporting guidance for other postretirement plans, including the Medicare prescription drug plan. Many public entities have already posted large noncash charges in early 2010 related to the nondeductibility of the subsidy.

.88 Some of the other provisions of the reform that may affect an entity's tax position include the nondeductible pharmaceuticals fee, the medical device excise tax, and the therapeutic discovery project tax credit, which will have an effect on the pharmaceutical and medical device industries. Additionally, employer group health plans may not impose lifetime limits and can only impose "restricted" annual limits beginning with the 2011 plan year (for calendar year plans); no annual limits would be permitted beginning in 2014. Because these health benefits can no longer be limited, entities may need to increase accruals for future medical obligations. Many small businesses and tax-exempt organizations that provide health insurance

coverage to their employees will now qualify for a special tax credit that is designed to encourage small employers to offer health care coverage for the first time or maintain the coverage they have. Lastly, under the new reform, a 40 percent penalty will apply to tax understatements attributable to transactions lacking economic substance (20 percent with adequate disclosure) or failing to meet the requirements of any similar rule of law. A transaction is treated as having economic substance only if the transaction changes in a meaningful way (apart from federal income tax effects) the taxpayer's economic position, and the taxpayer has a substantial purpose (apart from federal income tax effects) for entering into the transaction.

.89 The full text of these acts can be found at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ152.111.pdf and http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ148.111.pdf. Readers are also encouraged to refer to the Audit Risk Alerts *Health Care Entities—2010/11* (product no. 0223410) and *Not-for-Profit Entities—2010* (product no. 0224210).

Public Company Accounting Oversight Board Constitutionality

.90 On June 28, 2010, the Supreme Court ruled in the lawsuit challenging the constitutionality of the Public Company Accounting Oversight Board (PCAOB). When the PCAOB was set up under the Sarbanes-Oxley Act of 2002 (SOX), its board members were appointed by the SEC and could be removed only for cause.

.91 The Supreme Court ruled, in a 5-4 vote, that although the manner in which the PCAOB was constituted was constitutionally invalid, SOX itself was not invalidated. Rather, the Supreme Court severed from the rest of SOX the provisions relating to the removal of PCAOB board members. The consequence of the Supreme Court's decision is that PCAOB board members will now be removable by the SEC at will, instead of only for good cause. Essentially, this decision has no material impact on the workings of the PCAOB, and all PCAOB programs will continue to operate as usual, including registration, enforcement, and standard-setting activities.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.92 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients in prior years. Some risks that may affect an entity in the current economic environment are as follows:

- Marginally achieving explicitly stated strategic objectives
- Volatile real estate and business markets
- Significant measurement uncertainty, including accounting estimates and fair value measurements
- Potentially erroneous or fraudulent activity due to decreased staffing and resurgence of business activity
- The continuing evolution of the postrecessionary marketplace
- Revenue recognition and cash flow issues with respect to a customer's ability to pay

.93 Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constant changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

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.94 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

Auditing Debt Covenant Compliance

.95 Due to the nature of the real estate and construction industry, which often requires significant debt, the auditor should pay special attention to loan terms, including covenant clauses. Violations of loan covenants can have a material effect on the organization's ability to continue operations. The auditor should carefully review loan agreements and test for compliance with loan covenants. In this regard, consider any "cross default" provisions (that is, a violation of one loan covenant that affects other loan covenants). Keep in mind that any debt with covenant violations that is not waived by the lender for a period of more than one year from the balance sheet date may need to be classified in the balance sheet as a current liability.

.96 As always, review the debt payment schedules and consider whether the company has the ability to pay current debt installments or to refinance the debt, if necessary. When making an evaluation, it is important to remember that it is quite possible that the company will not generate as much cash flow as it did in previous years.

.97 Debt covenant compliance has recently become an issue of concern for many more entities than in the past. As the economic conditions declined, a greater number of entities began missing scheduled payments, defaulting, or entering bankruptcy protection. Lenders have become more concerned and have begun demanding more in return for their capital in the form of higher interest, stricter covenants, and a decreased willingness to issue waivers to entities for their covenant breaches.

.98 Lastly, due to the current nature of the economy and the overall health of the lending market, changes to the debt carried by companies may be more common. With this increased treatment comes a greater risk of improper accounting for the extinguishment of debts. For example, upon refinancing of debt, some instruments may contain prepayment penalties or defeasance costs, which may result in a loss on debt extinguishment instead of a capitalized cost. FASB ASC 405, *Liabilities*, outlines the requirements and accounting treatment regarding when a liability is considered extinguished and when and how it should be derecognized from an entity's balance sheet.

Engagement Quality Review for Issuers

.99 In January 2010, the PCAOB announced that the SEC had approved Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which was adopted by the PCAOB in July 2009. Auditing Standard No. 7 provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. Auditing Standard No. 7 is expected to increase the likelihood that a registered public accounting firm will catch any significant deficiencies before it issues its audit report. As a result, more work may be necessary under this standard than performed under the existing requirements for concurring partners. However, Auditing Standard No. 7 explains that the procedures required by the engagement quality reviewer are different in nature than those required to be performed by the engagement team. Further, if the engagement quality reviewer deems more work is required before giving approval of issuance, the engagement team is responsible for completing that work.

.100 This standard applies to all audit engagements and engagements to review interim financial information, conducted pursuant to the standards of the PCAOB, and it supersedes the PCAOB's interim concurring partner review requirement. Auditing Standard No. 7 is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009. For a public, calendar-year company, this standard is applicable for the quarter ended March 31, 2010. Subsequent to the issuance of Auditing Standard No. 7, the PCAOB issued Staff Question and Answer, *Auditing Standard No. 7*, Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10),

to provide further implementation guidance on the documentation requirements of the standard. For the full text of the standard and the question and answer, readers are encouraged to visit the PCAOB's website at www.pcaob.org.

Supplementary and Other Information Related to Financial Statements

.101 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

.102 Because construction contractors normally produce supplementary schedules for the users of their financial statements, including backlog and other contract information, the following Statements on Auditing Standards (SASs) may have an immediate and significant effect on the preparers of the financial statements and those auditing, reviewing, or compiling that information on their behalf.

Other Information in Documents Containing Audited Financial Statements

.103 SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information. *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information, of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

Supplementary Information in Relation to the Financial Statements as a Whole

.104 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of generally accepted auditing standards (GAAS), *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

.105 The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This SAS also may be applied, with the report wording adapted as necessary, when an auditor has been engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

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Required Supplementary Information

.106 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558), addresses the auditor's responsibility with respect to required supplementary information. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. SAS No. 120 explains that the objectives of the auditor, when a designated accounting standard setter requires information to accompany an entity's basic financial statements, are to perform specified procedures in order to

- describe, in the auditor's report, whether required supplementary information is presented, and
- communicate therein when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter, or when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter.

Auditing Fair Value Measurements

.107 In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with U.S. generally accepted accounting principles (GAAP), auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

.108 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable market price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor evaluates whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB ASC 820, *Fair Value Measurements and Disclosures*, under U.S. GAAP, this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.

- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)
- The reasonableness of the determination within the fair value hierarchy of inputs.

Fair Values of Securities

.109 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective. In the context of FASB ASC 820, quoted prices in active markets are considered level 1 inputs.

.110 When an entity performs its own valuation, value testing procedures include the following:

- Assessing the reasonableness
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

.111 Whether the inputs to the entity's valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB ASC 820. When extensive judgment is needed, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability of the security, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.112 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles. The auditor also should evaluate management's conclusions regarding other-than-temporary impairment on its securities. Examples of factors that could cause an other-than-temporary impairment, per paragraph .47 of AU section 332, include the following:

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- Fair value is significantly below cost and
  - the decline is attributable to adverse conditions specifically related to the security or to specific conditions in an industry or in a geographic area.
  - the decline has existed for an extended period of time.
  - management does not possess both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.
- The security has been downgraded by a rating agency.
- The financial condition of the issuer has deteriorated.
- Dividends have been reduced or eliminated, or scheduled interest payments have not been made.
- The entity recorded losses from the security subsequent to the end of the reporting period.

.113 Auditors should consider all facts and circumstances when determining if an other-than-temporary impairment has occurred. Additionally, the classification of an entity's securities is based on management's intent and ability. The auditor should obtain an understanding of management's classification process among trading, available-for-sale, and held-to-maturity, as well as consider the classifications in light of the entity's current financial position.

Auditing Accounting Estimates

.114 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, impairment analysis and estimated useful lives of long lived assets, valuation allowance for deferred tax assets, and actuarial assumptions in pension and other postretirement benefit costs.

.115 Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

.116 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet earnings, a key aspect of AU section 342 is for an auditor to determine the reasonableness of management's accounting estimates with an extra degree of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.117 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias.

.118 In all economic environments, the first steps in auditing construction estimates are to identify the estimates made and determine which are significant to the overall costs to complete the project and, therefore, recognize revenue. When evaluating construction contract estimates, the auditor may consider key factors and assumptions that are significant to the accounting estimates, sensitive to variations, subjective and susceptible to misstatement and bias, and deviations from historical patterns. The auditor might consider the historical experience of the entity in making past estimates, as well as the auditor's experience in the industry. However, changes in facts, circumstances, or the entity's procedures may cause factors different from those considered in the past to become significant to the accounting estimate. Thus, although a positive history of reasonable estimates may exist, current economic conditions may be cause for the auditor to more carefully examine the underlying inputs, the considerations, and the reasonableness of the expected results.

.119 When testing estimates, an auditor may review an up-to-date cost to complete analysis and perform a comparison to estimates used as of the financial statement date. Additionally, an auditor may analyze completed contracts to both understand the historic trends of the entity and to help identify areas in which the entity has incorrectly estimated in the past. Reviewing supporting documentation for costs that can be estimated with a minimal degree of complexity, such as subcontract costs and material purchased, also is a key step in the process. Further, recently completed contracts may give the auditor additional insight about the current business practices of the company in the current economy and allow for greater confidence in the estimates.

.120 Of particular interest to the construction industry is the consideration of unapproved or pending change orders and their effect on estimated contract values. Due to the current economic climate and general bonding requirements, the risk of a contractor including unapproved or pending change orders in their contract values has increased. Auditors should consider evaluating contract values and consider evaluating any pending change orders recorded. If pending change orders are recorded, the auditor should consider whether the approval of pending change orders is probable, the history of pending change order approval on the particular contract, and specifically consider any mark up included in the pending change order.

.121 For further details on auditing estimates, see AU section 342. The AICPA has released a proposed redrafted SAS on auditing accounting estimates, including fair value. Readers are encouraged to remain alert for developments on this topic.

Using the Work of a Specialist

.122 It may be necessary to use a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.

.123 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements. In July 2010, the PCAOB issued Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06), because it observed that a number of registered public accounting firms located in the United States have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the United States. Auditors of issuers should consult this practice alert for reminders concerning their obligations when using the work of other firms or using assistants engaged from outside the firm, such as in the aforementioned situation.

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Communicating Internal Control Related Matters Identified in an Audit

.124 SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), amends SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, and further clarifies standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted.

.125 The SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion), except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1). In general, SAS No. 115 retains many of the provisions of SAS No. 112. The key differences between the two standards lie in the definitions of *material weaknesses* and *significant deficiencies*.

Definitions of Significant Deficiency *and* Material Weakness

.126 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable*, as those terms are defined in the FASB ASC glossary. The FASB ASC glossary defines *reasonably possible* as the chance of the future event or events occurring is more than remote but less than likely; *probable* is defined as the future event or events are likely to occur. These definitions are consistent with those that appeared in FASB Statement No. 5, *Accounting for Contingencies*. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

The Evaluation Process

.127 Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. Further, the severity of a deficiency does not depend on whether a misstatement actually occurred.

.128 The AICPA published the Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Compilation and Review Engagements

.129 The AICPA developed a brand new guide, *Compilation and Review Engagements*, which provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

Accounting Issues and Developments

.130 Given the current economic climate, auditors should consider a number of accounting and financial reporting issues, such as the following:

- Fair value, including fair value measurements in illiquid markets
- Impairment
- Consolidation of variable interest entities
- Joint venture accounting

FASB Statement No. 168

.131 FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, as codified in FASB ASC 105, *Generally Accepted Accounting Principles*, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in their financial statements.

Referencing FASB ASC in Your Documentation

.132 You should consider how your entity will reference FASB ASC in your documentation (policy and procedures, technical memorandums, financial statements and filings, engagement working papers, and so on). It is only prudent to reflect current U.S. GAAP in your documentation. The FASB Notice to Constituents (NTC) includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*." On the other hand, they do suggest using the detailed numerical referencing system in working papers, articles, textbooks, and related items.

.133 Also, because FASB ASC is not intended to change U.S. GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate. It is prudent to expect that audit, attest, or compilation and review working papers associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

.134 However, if your entity will continue to follow grandfathered guidance not included in FASB ASC, it would still be appropriate to reference those standards (and not FASB ASC). A listing of examples of grandfathered guidance can be found in FASB Statement No. 168.

.135 Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/FASBAccountingStandardsCodification.aspx.

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FASB References After the Codification

.136 In spring 2010, the AICPA judgmentally selected 50 SEC filers and reviewed their 2009 Form 10-Ks to see what type of references are actually being used in practice. All financial statements reviewed had a year-end between December 1, 2009, and January 31, 2010, when the FASB codification was fully effective for all of these entities. The entities selected comprised the following:

- Fourteen large accelerated filers (28 percent of the sample)
- Twenty accelerated filers (40 percent of the sample)
- Seven nonaccelerated filers (14 percent of the sample)
- Nine smaller reporting companies (18 percent of the sample)

.137 Of all the entities selected, 50 percent had gone to mostly plain English references in their annual financial statements. However, among these entities, in the "Summary of Significant Accounting Policies" section of the financial statements, many entities did still use specific references to either old FASB standards (pre-FASB Statement No. 168 standards or legacy standards) or specific Accounting Standards Updates (ASUs), when appropriate. There did not seem to be much of a difference in this percentage among large accelerated filers, accelerated filers, and nonaccelerated filers. However, smaller reporting companies were less likely to use plain English (only 33 percent used plain English references).

.138 As for the remaining 50 percent of filers selected, they chose to use either FASB ASC-specific references (36 percent) or to do some sort of dual references (12 percent) between the precodification standards and new FASB ASC guidance. One entity continued to use the old FASB references and did not mention FASB ASC in its financial statements.

.139 For those entities using FASB ASC references, most only referenced to the topic level and did not go down to the subtopic or section level. For those using dual references, in most cases, the new FASB ASC topic was listed first, with the historical FASB reference noted parenthetically. See the following table for a full breakout of the results:

	Plain English References	*FASB ASC References*	*Dual References*	*Old FASB References*
Large Accelerated Filers	7	4	2	1
Accelerated Filers	12	6	2	0
Nonaccelerated Filers	3	3	1	0
Smaller Reporting Companies	3	5	1	0
Total Sample	25	18	6	1

.140 What this sampling shows us is that although both FASB and the SEC have stated that the use of plain English is most appropriate when dealing with financial statements and notes to financial statements, not everyone is there yet. It will be interesting to see if the plain English references trend continues upward once entities have had another full year to get used to FASB ASC. In addition, all new guidance issued in 2010 was issued through ASUs, and there were no legacy standards issued. Therefore, we would expect that in 2010 filings, even the "Summary of Significant Accounting Policies" section of financial statements would no longer refer to any legacy standards.

.141 We found that with the plain English references, some entities chose instead to say something like, "in accordance with the purchase method of accounting and as updated with FASB's April 2009 additional authoritative guidance for business combinations, we ...." Here the entity uses plain English but also makes

it clear which new guidance they are following. This would be most important for those FASB changes with early adoption provisions to make it clear which method an entity used.

.142 FASB has stated that ASUs do not carry any authority. It is the updates that are made to the codification once the ASU is effective that are authoritative. Therefore, entities would be wise to ensure that when they are referring to authoritative literature, use of either plain English or the FASB ASC references would be appropriate, rather than just naming the ASU that brought about the change in accounting.

.143 In addition, entities would want to be sure that they do not refer to any legacy standards in their 2010 financial statements. Because all changes made to the codification in 2010 were through ASUs, referring to legacy standards is no longer correct. For example, since the codification became effective, there have been several updates to the *Fair Value Measurements and Disclosures* topic. Therefore, referring to FASB Statement No. 157, *Fair Value Measurements*, is no longer accurate because this standard does not incorporate changes made since the codification became effective in 2009. We would expect that entities that used dual references to both the legacy standards and FASB ASC references would not continue to use those dual references in 2010 financial statements.

.144 Many entities also have a section of their notes to financial statements titled "Effect of Accounting Pronouncements Not Yet Adopted." In 2010, we would expect the title of this section to change to something like "Effect of Authoritative Accounting Guidance Not Yet Adopted."

.145 It will be interesting to see if both public and nonpublic entities make any additional refinements or changes to their 2010 financial statements as we move into our first full year with FASB ASC. It is our understanding that the SEC may be issuing comment letters to those entities that are not properly reflecting the current state of U.S. GAAP in their financial statements, whether that be by using plain English or using the new FASB ASC references.

Decreases in Ownership of a Subsidiary

.146 In January 2010, FASB issued ASU No. 2010-02, *Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*. This ASU addresses implementation issues related to the changes in ownership provisions in FASB ASC 810-10 (issued as FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements—an amendment of ARB No. 51*). These amendments clarify that the scope of the decrease in ownership provisions of FASB ASC 810-10 and related guidance applies to a subsidiary or group of assets that is a business or nonprofit activity, a subsidiary that is a business or nonprofit activity that is transferred to an equity method investee or joint venture, and an exchange of a group of assets that constitutes a business or nonprofit activity for a noncontrolling interest in an entity (including an equity method investee or joint venture). Further, the amendments clarify that the decrease in ownership guidance in FASB ASC 810-10 does not apply to the following transactions, even if they involve businesses: sales of in-substance real estate and conveyances of oil and gas mineral rights. The amendment also expands the required disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of FASB ASC 810-10. This ASU is effective beginning in the period that an entity adopts FASB Statement No. 160. If an entity has already adopted this guidance, then the amendments in this ASU are effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this ASU should be applied retrospectively to the first period that an entity adopted FASB Statement No. 160.

Accounting for Uncertainty in Income Taxes

.147 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities, and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

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- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.
- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FASB ASC 740-10-50-15[a]–[b]).

.148 For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009.

Consolidation of Variable Interest Entities

.149 For calendar year entities, 2010 is the first year of application of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB Statement No. 167 was incorporated into FASB ASC through ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*. This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited.

.150 The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly affect the entity's economic performance. This statement also amends consolidation of variable interest entities (VIE) guidance to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

.151 Entities will be required to provide additional disclosures about involvement with VIEs and any significant changes in risk exposure due to that involvement. Entities also will be required to disclose how involvement with a VIE affects the entity's financial statements.

.152 FASB Statement No. 167 retains the scope of previous VIE consolidation accounting guidance, with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140*, which was incorporated into FASB ASC by ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*.

.153 This statement also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a VIE or disclose information about its involvement in a variable interest entity, or both

- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks associated with an enterprise's involvement with the VIE
- How an enterprise's involvement with the VIE affects the enterprise's financial position, financial performance, and cash flows

Accounting for Transfers of Financial Assets

.154 Calendar year entities must also start applying the provisions of FASB Statement No. 166 in 2010. FASB Statement No. 166, which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, requires more information about transfers of financial assets, including securitization transactions, and where entities have continuing exposure to the risks related to transferred financial assets. FASB Statement No. 166 was incorporated into FASB ASC by ASU No. 2009-16 and is discussed in FASB ASC 860, *Transfers and Servicing*. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. It is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

.155 Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance.

.156 The primary objectives of the disclosure requirements of this guidance are to provide the financial statement users with a clear understanding of the following:

- A transferor's continuing involvement (as defined by the FASB ASC glossary), if any, with transferred financial assets
- The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- How servicing assets and servicing liabilities are reported under this pronouncement
- For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows

.157 These objectives must be met by the disclosures, regardless of the specific requirements of the pronouncement. It may be the case that an entity provides greater detail than what is a required disclosure to meet these objectives, depending on the facts and circumstances.

Subsequent Events

.158 FASB Statement No. 165, *Subsequent Events*, which has been codified in FASB ASC 855, *Subsequent Events*, is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosures of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date

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through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued). The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

.159 In particular, this statement sets forth the following:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

.160 FASB states that this guidance should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. In September 2009, the AICPA issued Technical Questions and Answers (TIS) section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), which notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. This question and answer can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

.161 In February 2010, FASB issued ASU No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, to address questions that arose in practice about potential conflicts between FASB ASC 855 and SEC guidance—specifically, the requirements to disclose the date that the financial statements are issued. This ASU also addresses the intended breadth of the reissuance disclosure provision related to subsequent events.

.162 ASU No. 2010-09 requires an entity that is an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market to evaluate subsequent events through the date the financial statements are issued. All other entities must evaluate subsequent events through the date the financial statements are available to be issued. Further, an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. Lastly, only non-SEC filers should disclose in the revised financial statements the dates through which subsequent events have been evaluated in both the issued or available-to-be-issued financial statements and the revised financial statements. Revised financial statements are considered reissued financial statements.

.163 The amendments in ASU No. 2010-09 are effective upon issuance, except for the use of the issued date for conduit bond obligors. That amendment is effective for interim or annual periods ending after June 15, 2010. In June 2010, the AICPA issued TIS section 8700.03, "Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor" (AICPA, *Technical Practice Aids*), to provide guidance related to the effect of this ASU on the auditor's responsibilities for subsequent events relative to a conduit debt obligor and the date of the auditor's report.

Fair Value

.164 FASB ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity. *Fair value* is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Measuring Liabilities at Fair Value

.165 FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value* to increase the consistency in the application of FASB ASC 820 to liabilities because many constituents had expressed concern. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10.

.166 This ASU states that, in circumstances in which a quoted price in an active market for the identical liability is not available, fair value of the liability must be measured by either (*a*) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities, or similar liabilities when traded as assets, or (*b*) another valuation technique that is consistent with the principles of FASB ASC 820, such as an income approach or a market approach. Further, if a restriction on the transference of the liability exists, the ASU clarifies that an entity is not required to factor that in to the inputs of the fair value determination. Lastly, the ASU also clarifies that a quoted price in an active market for the identical liability, or an unadjusted quoted price in an active market for the identical liability, when traded as an asset, are level 1 measurements within the fair value hierarchy. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after its issuance in August 2009. The full text of the ASU can be accessed from FASB's website at www.fasb.org.

Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

.167 FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both

- does not have a *readily determinable fair value*. The FASB ASC glossary states that an equity security has a readily determinable fair value if it meets any of the following conditions:
  - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year.
  - The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.
  - The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.
- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes are not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies.*

.168 As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the net asset value (NAV) per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

.169 This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the

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measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

.170 These amendments are effective for interim and annual periods ending after December 15, 2009 and are included in FASB ASC 820-10. An AICPA practice aid, *Alternative Investments—Audit Considerations*, also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments.

.171 In December 2009, the AICPA issued sections .18–.27 of TIS section 2220, *Long-Term Investments* (AICPA, *Technical Practice Aids*), to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers compliment the guidance provided in ASU No. 2009-12.

.172 Topics covered in these questions and answers include the following:

- The circumstances when NAV may be used to estimate the fair value of investments as a practical expedient
- How to identify the unit of account for interests in alternative investments
- Considerations for determining whether the reported NAV has been calculated in a manner consistent with FASB ASC 946
- Examples of circumstances when an adjustment to the reported NAV may be necessary
- How to adjust the reported NAV when it is not as of the reporting entity's measurement date
- How to adjust the reported NAV when it has not been calculated in accordance with FASB ASC 946
- The determination of the appropriate level within the fair value hierarchy for NAV of alternative investments in relation to the ability to redeem the investment versus the actual redemption request for the investment
- The definition of *near term* for the purposes of determining the appropriate level within the fair value hierarchy
- The tailoring of disclosures categories to address the nature and risks of investments
- Some considerations for determining the fair value of alternative investments when not utilizing NAV as a practical expedient

.173 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurements Disclosures

.174 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers between the three levels and the underlying reasons for such transfers would be useful to financial statements users.

.175 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.176 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.177 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Convergence With International Financial Reporting Standards

.178 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and International Financial Reporting Standards (IFRSs) and eliminate the differences between them. In the Norwalk agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

SEC Work Plan for Consideration of IFRSs

.179 In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to the SEC's roadmap on its consideration of global accounting standards, including a confirmation of its continued support for the convergence of U.S. GAAP and IFRSs in order to narrow the differences between the two sets of standards. The SEC believes that a more comprehensive work plan is necessary to transparently lay out the work that must be done to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, time frame, and methodology for any such transition. Therefore, the SEC has indicated that it will carefully consider and deliberate whether these changes are in the best interest of U.S. investors and markets.

.180 The SEC directed its staff to execute a work plan, the results of which will aid the SEC in its evaluation of the impact that the use of IFRSs by U.S. entities would have on the U.S. securities market. The work plan includes consideration of IFRSs, both as they currently exist and after the completion of the various convergence projects underway by FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received on the roadmap, including the following:

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- Sufficient development and application of IFRSs for the U.S. reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRSs
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

.181 Beginning no later than October 2010, and frequently thereafter, the SEC staff will provide public progress reports on the work plan, as well as the status of the FASB and IASB convergence projects, until the work is complete. By 2011, assuming completion of these convergence projects and the staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. Commentors provided feedback on the timing discussed in the roadmap, suggesting that a four or five year time frame would be necessary to successfully implement a change in their financial reporting systems to incorporate IFRSs. Under that assumption, if the SEC determines in 2011 to incorporate IFRSs into the U.S. financial reporting system, the first time that U.S. entities would report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of Release No. 33-9109 and also can be found on the SEC's website at www.sec.gov.

International Financial Reporting Standard for Small and Medium-sized Entities

.182 The IASB issued *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs*) to be a self-contained global accounting and financial reporting standard applicable to the general purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs. *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability.

.183 The AICPA Governing Council recognizes the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, ET sec. 203 par. .01), gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs*, and a private company's expenditure of money, time, and effort to convert to *IFRS for SMEs*. Information about IFRSs and *IFRS for SMEs* can be found at www.ifrs.com.

Private Company Financial Reporting

.184 The AICPA and the Financial Accounting Foundation established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel also is sponsored by the National Association of State Boards of Accountancy. The "blue-ribbon panel" will provide recommendations through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies are needed. The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities taking more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries. The panel's issued report will be made available to the public, and the resulting action plan is expected to be exposed for public comment prior

to that plan being finalized. Although no deadline has been set for the panel's work, the recommendations are likely to come in 2010.

.185 During the July 2010 meeting of the panel, seven alternative models for private company financial reporting were discussed. Models based on IFRSs and a model that would have resulted in no change to private company financial reporting were eliminated. All remaining models would result in differences in GAAP for private and public entities; the main focus of the panel moving forward will be to select a model that is relevant to users of private company financial reports because this has become the overriding issue. The three primary models the panel agreed to focus on going forward are U.S. GAAP with Exclusions for Private Companies—with enhancements; U.S. GAAP—Baseline GAAP with Public Company Add-Ons; and Separate, Stand-Alone GAAP Based on Current U.S. GAAP. Most of the panel members also expressed their discontent with the current make-up of FASB and its heavy, but appropriate, focus on public companies. This led to another key discussion topic: the structure of whatever model is chosen—the current FASB; a restructured FASB (with greater private company representation); or a new, separate Private Company Standards Board under the oversight of the Financial Accounting Foundation.

Recent Pronouncements

.186 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.187 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801) Issue Date: December 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 801 to reflect changes in the compliance audit environment and incorporates the risk assessment standards. It requires the auditor to adapt and apply the AU sections of the AICPA's *Professional Standards* to compliance audits and provides guidance on how to do so. It is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.
SAS No. 116, *Interim Financial Information* (AICPA, *Professional Standards*, AU sec. 722) Issue Date: February 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 722 to accommodate reviews of interim financial information of nonissuers, including companies offering securities pursuant to Securities and Exchange Commission (SEC) Rule 144A or participating in private equity exchanges. It is effective for reviews of interim financial information for interim periods beginning after December 15, 2009. Earlier application is permitted.

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.
Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards) Issue Date: January 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard and its related amendments supersede the interim concurring partner review requirements and update the interim quality control standards. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB. The standard provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. It is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009.
PCAOB Staff Question and Answer, *Auditing Standard No. 7,* Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10) Issue Date: February 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This staff question and answer provides further implementation guidance on the documentation requirements of Auditing Standard No. 7 in light of comments the SEC received during its comment period.
PCAOB Staff Audit Practice Alert (PA) No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06) Issue Date: July 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert is intended to remind registered public accounting firms of their obligations when using the work of other firms or using assistants engaged from outside the firm. The alert was prompted by observations by the PCAOB that a number of registered public accounting firms located within the United States have been issuing reports on financial statements filed by issuers that have substantially all of their operations outside of the United States, and some of these firms may not be conducting those audits in accordance with PCAOB standards.

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Recent Auditing and Attestation Pronouncements and Related Guidance	
PCAOB Staff Audit PA No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05) Issue Date: April 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert explains that significant unusual transactions, especially those close to period-end that pose difficult substance over form questions, can provide opportunities for entities to engage in fraudulent financial reporting. This staff audit practice alert is designed to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions.

Recent ASUs

.188 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.* However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC)	
Accounting Standards Update (ASU) No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
Liabilities Area of FASB ASC	
ASU No. 2009-15 (October 2009)	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2009-13 (October 2009)	*Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*

(continued)

Recent Accounting Standards Updates	
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
Broad Transactions Area of FASB ASC	
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2009-17 (December 2009)	*Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2009-12 (September 2009)	*Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*
ASU No. 2009-16 (December 2009)	*Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-03 (January 2010)	*Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-07 (January 2010)	*Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*
ASU No. 2009-14 (October 2009)	*Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*

Recent Technical Questions and Answers

.189 The following table presents a list of recently issued nonauthoritative audit and attest and accounting technical questions and answers issued by the AICPA. Recently issued questions and answers can be accessed

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at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Recent Technical Questions and Answers
(AICPA, *Technical Practice Aids*)

Technical Questions and Answers (TIS) section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"

(continued)

Recent Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments "
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"
TIS section 9150.26 (December 2009)	"The Accountant's Responsibilities for Subsequent Events in Compilation and Review Engagements"
TIS section 6910.33 (December 2009)	"Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination"
TIS section 2220.18 (December 2009)	"Applicability of Practical Expedient"
TIS section 2220.19 (December 2009)	"Unit of Account"
TIS section 2220.20 (December 2009)	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, *Financial Services—Investment Companies*"
TIS section 2220.21 (December 2009)	"Determining Whether an Adjustment to NAV Is Necessary"
TIS section 2220.22 (December 2009)	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"
TIS section 2220.23 (December 2009)	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
TIS section 2220.24 (December 2009)	"Disclosures—Ability to Redeem Versus Actual Redemption Request"
TIS section 2220.25 (December 2009)	"Impact of 'Near Term' on Classification Within Fair Value Hierarchy"
TIS section 2220.26 (December 2009)	"Categorization of Investments for Disclosure Purposes"
TIS section 2220.27 (December 2009)	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
TIS section 8700.01 (September 2009)	"Effect of FASB ASC 855 on Accounting Guidance in AU Section 560"
TIS section 8700.02 (September 2009)	"Auditor Responsibilities for Subsequent Events"

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Recent Technical Questions and Answers (AICPA, *Technical Practice Aids*)	
TIS section 6910.30 (July 2009)	"Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets"
TIS section 6910.31 (July 2009)	"The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the '5 Percent Test' Described in TIS Section 6910.30"
TIS section 6910.32 (July 2009)	"Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt"
TIS section 1500.07 (June 2009)	"Disclosure Concerning Subsequent Events in OCBOA Financial Statements"
TIS section 1600.04 (June 2009)	"Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements"

Internal Control Issues and Developments

Common Internal Control Issues in the Real Estate and Construction Industries

.190 Large layoffs, staff reductions, and notifications of impending termination to employees can affect internal control over financial accounting and reporting systems. Remaining employees may feel overwhelmed by their workloads and lack of time to complete tasks and consider decisions and may simply be performing too many tasks and functions to meet the required levels of accuracy. In addition, rapid changes in the business environment and changes in business strategies may outstrip the ability of a company's financial systems to remain under effective internal control. As a result of any of these factors, internal control may become less effective or even ineffective. Continued vigilance is crucial to ensure the effectiveness of established internal controls remains.

.191 Relevant considerations are whether

- the attention to internal control has been maintained in the face of significant changes in the business.
- as a result of eliminated positions, key control procedures are no longer being performed, are being performed less frequently, or are being performed by individuals lacking proper understanding to identify and correct errors.
- layoffs of IT personnel have had a negative effect on the entity's ability to initiate, process, or record its transactions or maintain the integrity of information generated by the IT system.
- key functions that should be segregated are now being performed by one person.
- the impact of changes to the control environment has altered internal control effectiveness and potentially resulted in a material control weakness.
- changes in internal control caused by past or pending layoffs or staff reductions create an opportunity for fraudulent activities, including misappropriation of assets.

Recent AICPA Independence and Ethics Pronouncements

.192 The Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

On the Horizon

.193 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the real estate and construction industries or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.194 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.195 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the first half of 2011. Two possible exceptions to that time frame include the clarity redrafts of AU sections 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, and 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1). In May 2010, the expected effective date was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

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Interim Financial Information

.196 In July 2010, the ASB issued two proposed SASs on interim financial information. The first, *Revised Applicability of Statement on Auditing Standards No. 116*, Interim Financial Information, is intended to revise paragraph 5 of SAS No. 116, *Interim Financial Information* (AICPA, *Professional Standards*, AU sec. 722), so that the guidance in SAS No. 116 would be applicable when the auditor audited the entity's latest annual financial statements and the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. Currently, the guidance in SAS No. 116 is applicable when the auditor performs the audit of the latest annual financial statements and expects to be engaged to audit the current year financial statements (and, therefore, is not applicable when the auditor expects that a new auditor may be engaged for the current year). This proposed amendment would be effective for interim reviews of interim financial information for periods beginning after December 15, 2011, with early implementation permitted. Comments are due by October 8, 2010.

.197 The second proposal on interim financial information, *Interim Financial Information* (Redrafted), would supersede SAS No. 116 and represents the redrafting of the guidance to apply clarity drafting conventions. The main changes to existing standards are as follows:

- Replacement of the term *accountant* with *auditor*
- The change to paragraph 5 discussed in the prior paragraph
- Requirement of the auditor to issue a written report unless the review of the interim financial information is required by a third party and the third party does not require a written review report
- Allowance of oral reports for entities that are subject to external requirements to report in a manner that is substantially similar to the reporting required of issuers, pursuant to PCAOB standards
- Requirement for the auditor to perform procedures consistent with those required for acceptance of an engagement to audit financial statements
- Requirement for the review report to include a statement that the review of interim financial information was conducted in accordance with auditing standards generally accepted in the United States of America

.198 This proposed SAS would be effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2012. Comments for this proposed SAS are also due by October 8, 2010.

Exposure Drafts on Auditor's Reports

.199 The ASB issued three proposed SASs related to auditor's reports: *Forming an Opinion and Reporting on Financial Statements*, *Modifications to the Opinion in the Independent Auditor's Report*, and *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. These proposed standards are drafted with the ASB's clarity drafting conventions and are intended to converge with ISAs. The intent of issuing three separate SASs is to assist practitioners in identifying and applying the reporting requirements and guidance. The ASB has made various changes to the related ISAs to tailor them to the United States; however these changes have not been substantial in nature.

.200 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Exposure Drafts on Special Considerations Audits

.201 Another exposure draft issued by the ASB contains two proposed SASs: *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* and *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. These proposed

standards have been drafted with the clarity drafting conventions and are intended to converge with the equivalent ISAs. No meaningful differences exist between these proposed standards and the ISAs. *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* addresses the application of GAAS to financial statements prepared under the cash, tax, regulatory, or contractual bases of accounting. It also replaces the term *other comprehensive basis of accounting* with *special purpose framework*.

.202 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* introduces new planning, performance, and reporting requirements for these engagements. The proposed SAS also clarifies that a single financial statement and a specific element of a financial statement include the related notes.

.203 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Auditing and Attestation Pipeline—Issuers

Confirmations

.204 The PCAOB has proposed a draft of an auditing standard on confirmations. A concept release was originally issued in April 2009 and received 24 comment letters. This proposed auditing standard, issued in July 2010, would strengthen the requirements under the current auditing standard, AU section 330, *The Confirmation Process* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and replace it, upon final issuance of a standard and approval from the SEC. The proposed new standard

- requires confirmation procedures for specific accounts, such as receivables that arise from credit sales, loans, or other transactions, and also in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.
- incorporates procedures in response to the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating nonresponses to confirmation requests.
- updates the confirmation guidance to reflect significant advances in technology and explains that confirmation responses received electronically (for example, by fax e-mail, through an intermediary, or direct access) might involve additional risks relating to reliability. Therefore, the auditor must perform additional requirements.
- defines a confirmation response to include electronic or other medium.
- enhances requirements when confirmation responses include disclaimers and restrictive language by requiring the auditor to evaluate the effect on the reliability of a confirmation response. Further, if the disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

.205 In drafting this proposed standard, the PCAOB considered the guidance contained in ISA 505, *External Confirmations*, and the AICPA's proposed guidance on confirmations. This standard is anticipated to be effective for auditors for fiscal years ending on or after December 15, 2011.

Communications With Audit Committees

.206 In March 2010, the PCAOB proposed for comment an auditing standard on *Communications with Audit Committees* and a series of related amendments to its interim standards that are intended to (*a*) enhance the relevance and effectiveness of the communications between the auditor and the audit committee and (*b*) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. Two of the new requirements would be for the auditor (*a*) to establish a mutual understanding of the terms of the audit engagement with the audit committee and to document that understanding in the engagement letter and (*b*) to evaluate the adequacy of two-way

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communication between the auditor and audit committee. Additionally, the proposal also includes requirements for the auditor to communicate with the audit committee regarding the following:

- An overview of the audit strategy and timing of the audit, including a discussion of significant risks; the use of the internal audit function; and the roles, responsibilities, and location of firms participating in the audit
- Critical accounting policies, practices, and estimates
- The auditor's evaluation of the entity's ability to continue as a going concern

.207 The proposed standard would become effective, subject to SEC approval, for audits of fiscal years beginning after December 15, 2010.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.208 FASB expects 2010 to be a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. Most recently, FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Other MoU projects
- Other joint projects

.209 A progress report for the quarter ended March 31, 2010, highlighted the following topics: (*a*) on the financial instruments and insurance contracts topics, the boards have reached different conclusions on significant technical issues that may affect the project timetables of these topics and (*b*) the boards agreed to explore an alternative approach to lessor accounting that may affect the project timetable of this topic. FASB and the IASB also have several other joint projects in process, including balance sheet—offsetting, emissions trading schemes, and reporting discontinued operations. In March 2010, the exposure draft *Conceptual Framework for Financial Reporting* was published for public comment. In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. Specifically, the boards were scheduled to expose for comment numerous major exposure drafts during the second quarter of 2010, and stakeholders voiced concern about their ability under those circumstances to provide high-quality input. The boards have developed a modified strategy to accommodate these concerns by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate consultation document seeking stakeholder input about effective dates and transition methods.

.210 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. The boards also decided to issue separate exposure drafts to address differences in the two sets of standards on balance sheet netting of derivative contracts and other financial instruments. The IASB has also made its projects on improved disclosures about derecognized assets and other off balance sheet risks, consolidations, and insurance contracts priorities. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, have been extended into the second half of 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively affect the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the U.S. financial system.

.211 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Comprehensive Income Exposure Draft

.212 In May 2010, FASB issued a proposed ASU on comprehensive income that would require an entity to report total comprehensive income in a continuous financial statement in two parts: net income and other comprehensive income. In that financial statement, the components of net income and the components of other comprehensive income should be displayed. The proposed ASU is intended to simplify how comprehensive income is reported by eliminating two options for how items of comprehensive income are displayed. The proposed ASU contains illustrative examples of the revised financial statement. This proposed ASU is the result of a joint project as part of IFRSs and U.S. GAAP convergence, and the IASB has separately issued a similar document. The proposed amendments would be applied on a fully retrospective basis to improve comparability between reporting periods. Further, because compliance with the proposed amendments is already permitted, early adoption would be permitted. FASB plans to align the effective date with the effective date of the amendments in the proposed ASU on financial instruments. The IASB and FASB aim to finalize an improved and converged standard on other comprehensive income in the fourth quarter of 2010.

Financial Instruments Exposure Draft

.213 Also, in May 2010, FASB issued a proposed ASU on accounting for financial instruments, derivative instruments, and hedging activities. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments; removes the threshold for recognizing credit impairments, creating a single credit impairment model for both loans and debt securities; and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.
- Changes in fair value of equity securities, certain hybrid instruments, and financial instruments that can be prepaid in such a way that the holder would not recover substantially all of its investment would be recognized in net income each reporting period regardless of an entity's business strategy for those financial instruments.
- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, a reconciliation from amortized cost to fair value would be required on the statement of position; with the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other

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comprehensive income each reporting period. Therefore, net income will remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period.

- The existing probable threshold for recognizing impairments on loans would be removed. (Currently, FASB ASC 310-10-35-4 states that the concept in U.S. GAAP is that impairment of receivables [including loans] should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. *Probable* is defined by FASB ASC 310-10-20 as when the future event or events are likely to occur.)
- For changes in the value of financial instruments measured through other comprehensive income, an entity is required to determine if a credit impairment is appropriate at the end of each reporting period based on information related to past events and existing economic conditions. An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts the entity does not expect to collect.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected, which would better reflect a financial instrument's interest yield.
- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.
- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.214 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments). This proposed ASU was not issued jointly with the IASB and does not contain converged guidance; however, the goal still remains for both boards to issue comprehensive improvements to foster international comparability of financial information about financial instruments. The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009. The IASB also issued 2 exposure drafts on amortized cost and impairment and fair value option for financial liabilities in late 2009 and mid-2010, respectively; the third topic, hedge accounting, is still being deliberated by the IASB, and an exposure draft is expected in the near term. The boards have stated that they will consider together the comment letters and other feedback received on each board's exposure drafts in an effort to reconcile their differences in ways that foster improvement and convergence. The effective date of these amendments will be established upon issuance of the final ASU, which is expected in the second quarter of 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional 4 years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

Revenue Recognition Exposure Draft

.215 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from*

Contracts with Customers, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.216 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities (for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (*performance obligation* is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).
- determine the transaction price (*transaction price* is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.217 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*) recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

Impact on the Construction Industry

.218 This change in the revenue recognition model is expected to have a large impact on the construction industry. A major concern in the construction sector is that the exposure draft puts an end to percentage-of-completion accounting and would, in effect, require that revenue and profits from construction only be recognized once a contract was complete and the asset was accepted by the client. Although the exposure draft does put an end to percentage of completion accounting, it does allow for accounting that would result in broadly similar accounting outcomes for the majority of the construction projects in which control of the building work-in-progress transfers to the customer as work is completed.

Performance Obligations

.219 As noted in the preceding five-step model approach, entities would be required to identify the separate performance obligations within contracts with customers, to the extent that the performance

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obligations are *distinct*. A *performance obligation* is defined in the exposure draft as an enforceable promise in a contract with a customer to transfer a good or service to that customer. A performance obligation is considered to be *distinct* if the entity or another entity sells an identical or similar good or service separately; or because the entity could sell the good or service separately because it has a distinct function and a distinct profit margin. Revenue is then recognized as those performance obligations are satisfied by transferring goods and services to the customer. The performance obligation is deemed to be satisfied when the customer *obtains control* of the promised good or service.

.220 The key issue that arises from this concept is determining when performance obligations should be accounted for separately. The exposure draft contains several examples that aim to illustrate how to apply this approach to a construction contract. Example 11 in the exposure draft concludes that the design activity is a separate performance obligation because similar services are sold separately by the entity and by its competitors, and that site preparation and site finishing are separate performance obligations because they have distinct risks. Accordingly, these elements would be accounted for separately. However, in this example, all other elements of the contract, including contract management and procurement, would be treated as a single performance obligation and would be accounted for together.

.221 This example demonstrates select items that would and should be separated; however, most contracts are complex and may not have bright-line elements, which would easily be separated.

Satisfaction of Performance Obligations

.222 The exposure draft proposes that an entity should recognize revenue when a performance obligation is satisfied, and that each performance obligation would be satisfied when the customer obtains control of the goods or services. The exposure draft continues to state that control passes when the customer has the ability to direct the use of the asset or the ability to receive the benefit from the asset.

.223 For the construction industry, the key question will be whether the customer has control of the construction work-in-progress or the partially completed asset. This distinction can be difficult to determine and may involve a legal determination, including restrictions and permissions under local property law.

Continuous Transfer Concept

.224 The exposure draft states that cases exist in which control of the goods or services transfers to the customer on a continuous basis. This concept would allow entities to achieve accounting results similar to the percentage-of-completion method currently allowed under existing accounting guidance. If the customer obtains control of the goods or services on a continuous basis, then the entity would apply the revenue recognition method that best depicts the transfer of goods or services so as to recognize the amount of the performance obligation satisfied during each reporting period.

.225 The exposure draft outlines suitable methods to depict continuous transfer, which include the following:

- Output methods, that is, milestones, units produced or delivered
- Input methods, that is, costs or efforts expended to date
- Methods based on the passage of time, suitable for services transferred over a period of time

.226 The determination regarding whether the transfer of control takes place at a point in time or over a continuous basis is a critical accounting judgment and would be the basis for revenue recognition by the entity.

Additional Concerns for Construction Contractors

.227 Retrospective application of the standard is proposed, which would provide a significant challenge to contractors to assess each of their existing contracts under the proposed guidance. Such a task would

require a deep examination of each contract and the performance obligations that exist and their state of transfer.

.228 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the boards plan to invite additional comment through a separate consultation on how best to transition over to the new standards. Therefore, no expected specific effective date is stated at this point. Comments on the exposure draft are due on October 22, 2010. This topic is considered by many to be the most pervasive of any FASB has ever worked on. The reader is encouraged to review the exposure draft, consider if it is operational to you or your clients' common revenue transactions, and share any resulting concerns with FASB. The boards also anticipate holding public roundtable meetings after the end of the comment period.

Fair Value Exposure Draft

.229 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.230 The first two of these significant amendments are intended to clarify the application of existing fair value measurement guidance. The last three of these significant amendments would change a particular principle of fair value guidance.

.231 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines *highest and best use* as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values do not depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.232 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

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.233 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to interest rate risk, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice. However, they might affect the current practice for reporting entities that apply the in-use valuation premise more broadly.

.234 The proposed amendments regarding the application of blockage factors and other premiums and discounts in fair value measurements would make two changes to current guidance. Currently, under U.S. GAAP, use of a blockage factor in fair value measurements is only prohibited when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities). This would be level 1 within the fair value hierarchy. The first change from the proposed amendments is that a blockage factor is not relevant and, therefore, also should not be used when fair value is measured using a valuation technique that does not use a quoted price. This would be level 2 or level 3 within the fair value hierarchy. Second, the amendments specify that fair value measurements categorized within level 2 and level 3 take into account other premiums and discounts when market participants would consider those premiums or discounts when pricing an asset or a liability, consistent with the unit of account for that asset or liability. Examples include a control premium or a noncontrolling interest discount. These proposed amendments may affect current practice for any reporting entities applying a blockage factor in fair value measurements that is measured using quoted prices and categorized within level 2 of the fair value hierarchy.

.235 Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

- The effect on a fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances
- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use
- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

.236 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs.

Financial Statement Presentation Staff Draft

.237 FASB and the IASB are working together to establish a common standard that would improve how information is organized and presented in financial statements. This common standard is intended to address users' concerns that existing requirements permit too many alternative types of presentation, and that information in financial statements is highly aggregated and inconsistently presented, making it difficult to

fully understand the relationship between an entity's financial statements and its financial results. In 2008, a discussion paper was issued by the boards that outlined the proposed principles for presenting financial statements in a way that portrays a cohesive financial picture of an entity.

.238 Given the magnitude of this project, the expected implementation costs, and the substantial effects it will have on financial statement presentation for many years to come, the boards decided in May 2010 to modify the strategy for this project. Before finalizing an exposure draft, the boards decided to engage in additional outreach activities that focus on the perceived benefits and costs of the proposals and the implications of the proposals for financial reporting by financial service entities. The boards plan on discussing these two areas of focus with preparers and users of financial statements. This outreach will be based on a rough draft of a proposed standard, known as a *staff draft*, and reflects the cumulative tentative decisions made by the boards, concluding with their joint meeting in April 2010. This staff draft was made publicly available solely for this purpose.

.239 The proposals in this project would be applicable to all entities, except a benefit plan within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*; 962, *Plan Accounting—Defined Contribution Pension Plans*; and 965, *Plan Accounting—Health and Welfare Benefit Plans* or IAS 26, *Accounting and Reporting by Retirement Benefit Plans*. The two core financial statement principles in this proposal are cohesiveness and disaggregation. A common structure for the statements of financial position, comprehensive income, and cash flows would be established in the form of required sections, categories or subcategory, and related subtotals. Some proposed specific changes in the classification and format of financial statements include the following:

- Related information would be displayed in the same sections, categories, and subcategory in each statement so that information is more easily associated.
- Presentation of business and financing activities would be separated as follows:
  - The business section would include items that are part of an entity's daily operations and other income generating activities.
  - The financing section would include items that are part of an entity's activities to obtain (or repay) capital.
- Discontinued operations and income taxes would be presented in their own separate sections.
- The statement of changes in equity would not include the sections and categories used in the other statements because that statement presents information solely about changes in items classified in the equity category in the statement of financial position.

.240 Further, FASB plans to propose some changes that are already required by IAS 1, *Presentation of Financial Statements*. The definition of, and the requirements for, a complete set of financial statements would become authoritative in U.S. GAAP. An entity would also be required to present one period of comparative information. A *complete set of financial statements* would consist of, at a minimum, statements of financial position, comprehensive income, cash flows and changes in equity, and notes to financial statements for two periods (the current period and the previous period). Also, an opening statement of financial position would be part of a complete set of financial statements if an entity applies an accounting principle retrospectively, restates its financial statements, or reclassifies items in the financial statements.

.241 The boards' tentative decisions on financial statement presentations do differ in a few ways in relation to minimum line requirements for the statement of financial position, segment reporting, and net debt presentation. Of these three, the differing stance on segment reporting is the only significant difference. The boards now aim to issue an exposure draft in the first quarter of 2011 and a final improved and converged standard in the fourth quarter of 2011. Both the introduction to the staff draft and the staff draft can be accessed from FASB's website at www.fasb.org.

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Auditing Considerations of Accounting Convergence

.242 Although the future of convergence between IASB and FASB accounting standards remains an unknown, discussions have already begun about the potential impact on auditors. Although auditors are accustomed to new standards, the nature and volume of these changes will likely pose new challenges. Among others, some of these potential challenges include the following:

- Training audit staff on a large amount of new accounting guidance that is based on an accounting approach (that is, principles based versus rules based)
- Developing, as necessary, any new internal audit guidance, such as firm methodology
- Implementing any new resulting auditing rules
- Creating a new framework for documenting audit conclusions on a principles-based accounting approach
- Audit committees learning new accounting guidance to effectively perform their function

.243 In addition to the challenges auditors will face, the effects on preparers will also be great. At the time of this writing, it appears that the transition timeline to convergence will be relatively short; this will divert resources during the preparation of financial statements as entities focus on implementing the new principles, which may result in increased audit risk. Auditors, in addition to preparers, are also encouraged to remain current on developments of international accounting convergence.

FASB Accounting Pipeline

Disclosure of Certain Loss Contingencies

.244 In July 2010, FASB issued an exposure draft on the disclosure of certain loss contingencies in response to concerns from investors and other financial statement users that the current disclosures do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. The objective of these disclosures would be for an entity to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following: the nature of the loss contingencies, their potential magnitude, and their potential timing (if known). Disclosure of certain remote loss contingencies would be required and, therefore, would expand the population of loss contingencies that are required to be disclosed. An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required. Further, current qualitative disclosures would be enhanced by requiring additional disclosures. These additional required qualitative and quantitative disclosures include the following:

- For litigation contingencies, the contentions of the parties and how users can obtain more information about the litigation
- Publicly available quantitative information, such as the claim amount for asserted litigation contingencies; other relevant nonprivileged information; and, in some cases, information about possible recoveries from insurance and other sources
- For public entities, tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the period

.245 The amendments in this proposal would affect all entities. The exposure draft noted that FASB will continue to work with the PCAOB, the AICPA, and the American Bar Association (ABA) to identify and address any potential implications of the proposed amendments for auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The proposed amendments would be effective for fiscal years ending after December 15, 2010, for public entities and in the first annual period beginning after December 15, 2010, for nonpublic entities. The comment period ended in August 2010.

Going Concern FASB Project

.246 Currently, the only guidance on going concern resides in the auditing literature, and this project's intention is to incorporate going concern guidance into U.S. GAAP. Specifically, this guidance would discuss the following:

- Preparation of financial statements as a going concern
- An entity's responsibility to evaluate its ability to continue as a going concern
- Disclosure requirements when financial statements are not prepared on a going concern basis
- Disclosure requirements when there is a substantial doubt about an entity's ability to continue as a going concern
- The adoption and application of the liquidation basis of accounting

.247 A revised exposure draft is expected to be issued in the fourth quarter of 2010, with a final ASU expected in the first quarter of 2011. FASB has decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Readers should be alert to developments on this topic.

Other Accounting Projects

.248 Additionally, FASB has the following projects underway:

- Troubled debt restructuring
- Disclosure framework
- Investment properties

Resource Central

.249 The following are various resources that practitioners engaged in the real estate and construction industries may find beneficial.

Publications

.250 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *Construction Contractors* (2010) (product no. 0125810 [paperback], WCC-xx [online with the associated Audit Risk Alert], or DCC-XX [CD-ROM with the associated Audit Risk Alert])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Audit Guide *Compilation and Review Engagements* (2010) (product no. 0128110 [paperback] or WRC-XX [online])
- Audit Guide *Auditing Revenue in Certain Industries* (2010) (product no. 0125110 [paperback] or WAR-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2009* (product no. 0223009 [paperback])

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- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2009* (product no. 0224709 [paperback] or WIA-XX [online])
- *Accounting Trends & Techniques, 63rd Edition* (product no. 0099009 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099109 [paperback] or WIF-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Financial Reporting Alert *Current Economic Crisis: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

AICPA Online Professional Library: Accounting and Auditing Literature

.251 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.252 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's AnnualAccounting and Auditing Update Workshop (2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Strong Foundation* (product no. 741602 [text], 181601 [DVD/Manual], or 351601 [Additional Manual for DVD]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

.253 Among the many courses, the following are specifically related to the real estate and construction industries:

- *Real Estate Accounting and Financial Reporting: Tackling the Complexities* (product no. 734622)
- *Real Estate Accounting and Auditing* (product no. 730610)
- *Advanced Real Estate Accounting, Auditing & Taxation* (product no. 745290)
- *FIN 46R Variable Interest Entity Consolidation Rules: Not Just a Big Company Issue!* (product no. 733214)
- *Construction Contractors: Accounting, Auditing, and Tax* (product no. 736434)
- *Construction Contractors Advanced Issues* (product no. 731996)

- *Accounting and Finance for Construction Contractors* (product no. 756442)
- *Taxation of Construction Contractors* (product no. 753561)

.254 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.255 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the real estate industry include the following:

- *Planning the Audit of a Real Estate Entity's Financial Statements*
- *Accounting for Sale—Leasebacks and Nonmonetary Exchanges*
- *Accounting for Rental Operations and Investments in Real Estate Ventures*
- *Accounting for the Sale of Real Estate Assets*
- *Accounting for the Impairment of Completed Real Estate Projects*
- *Auditing Real Estate Transactions*
- *Accounting for the Acquisition and Development of Real Estate Assets*

.256 Some topics of special interest to the construction industry include the following:

- *Construction Contractors: Nature of the Construction Industry*
- *Construction Contractors: Contract Accounting*
- *Construction Contractors: Audit Plan/Preliminary Analytical Procedures plus Substantive Audit Procedures*
- *Construction Contractors: Other Auditing Considerations*
- *Construction Contractors: Internal Control Issues in the Construction Industry*
- *Construction Contractors: Audit Risks in the Construction Industry*
- *Construction Contractors: Nature and Significance of the Construction Industry and Cost Allocations*

.257 To register or learn more, visit www.cpa2biz.com.

Webcasts

.258 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.259 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

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Hotlines

Accounting and Auditing Technical Hotline

.260 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.261 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

Industry Conference

.262 The AICPA offers an annual National Real Estate Conference in the fall. The National Real Estate Conference is a two day conference designed to update attendees on recent developments related to real estate accounting and auditing, tax, and management issues. It delivers solid news about the emerging trends in the real estate market while offering new ideas for the accounting and financial management of the real estate industry. The nationally-renowned speakers provide attendees with technical details, innovative ideas, and practical solutions. This conference also provides best practices, case studies, open forum discussions, and "ask the experts" exchanges. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

.263 The AICPA offers an annual National Construction Industry Conference in the fall. The National Construction Industry Conference is a two day conference designed to update attendees and offer instructive information and guidance for recent developments and upcoming changes in accounting, auditing, taxation, operations, marketing, and financial management. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

The Center for Audit Quality

.264 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.265 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit http://thecaq.aicpa.org.

Industry Websites

.266 The Internet covers a vast amount of information that may be valuable to auditors of real estate and construction entities, including current industry trends and developments. Some of the more relevant sites for auditors with real estate clients include those shown in the following table:

Organization	*Website*
American Securitization Forum	www.americansecuritization.com
CB Richard Ellis	www.cbre.com
Colliers International	www.colliers.com
Lodging Econometrics	www.lodging-econometrics.com
Mortgage Bankers Association	www.mbaa.org
Reis, Inc.	www.reis.com
National Association of Real Estate Investment Trusts	www.reit.com
National Association of Realtors	www.realtor.org
Real Estate Research Corporation	www.rerc.com
The Real Estate Roundtable	www.rer.org
RealtyTrac	www.realtytrac.com
Smith Travel Research, Inc.	www.strglobal.com
Urban Land Institute	www.uli.org

.267 Some of the more relevant sites for auditors with construction clients include those shown in the following table:

Organization	*Website*
The American Institute of Architects	www.aia.org
Associated Builders and Contractors	www.abc.org
The Associated General Contractors of America	www.agc.org
McGraw-Hill Construction	www.construction.com
National Association of Realtors	www.realtor.org
The Surety & Fidelity Association of America	www.surety.org

.268 The real estate and construction practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities.	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee)	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReview ServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org

(continued)

Website Name	*Content*	*Website*
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov

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AAM Section 8100

Investment Companies Industry Developments—2010/11

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Investment Companies Industry Developments—2009*.

This Audit Risk Alert is intended to provide auditors of financial statements of investment companies with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

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Feedback

The Audit Risk Alert *Investment Companies Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your investment company audits and also can be used by an entity's internal management. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) explains important issues that affect all entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

The Current Economy

.03 When planning and performing audit engagements, an auditor should understand both the general current economy and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

.04 The year 2010 may be the beginning of a wave of economic recovery. Although many key indicators, such as unemployment, are still uncomfortably high, 2010 began with rising commodity prices, a jump in new factory orders that caused the largest expansion in production in 3 years, and an increase in U.S. auto sales that approached prerecessionary levels. The National Bureau of Economic Research (NBER) determined that the recession officially began in December 2007 and ended in June 2009 based on a trough of business activity that occurred in the U.S. economy in June 2009. The trough marks the end of the business cycle's declining phase and the start of its rising phase. However, the NBER did not conclude that economic conditions have turned favorable or that the economy has returned to normal capacity. It also decided that any future downturn of the economy would be a new recession, not a continuation of the recently ended recession.

.05 Further, after experiencing a considerable decline in the stock market through March 2009, the markets have rebounded substantially. In March 2009, the S&P 500 and the Dow Jones Industrial Average (DJIA) reached their 12-year lows, and NASDAQ closed at its lowest point since October 2002. By March 2010, only a year later, all 3 had increased in value by at least 59 percent from the previous year's lows. All 3 remained relatively unmoved 6 months later, in late September 2010. However, stocks did end September on a high note; the DJIA had its biggest September gain in 7 decades, and the S&P 500 had its biggest gain since 1939. This exhibits the continuing uncertainty in the markets due to the varying economic indicators, the financial reform regulatory changes, and Europe's economy, among other reasons. The fear of a double-dip recession (a recession followed by a short-lived recovery followed by another recession) continues to loom over the U.S. economy. The research firm, StrategyOne reported in early September that 65 percent of Americans believe a double-dip recession is likely to occur.

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Key Economic Indicators

.06 These key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.07 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.6 percent in the second quarter of 2010 (second estimate), 3.7 percent in the first quarter of 2010, and 5.6 percent in the fourth quarter of 2009. This data indicates a turnaround in the economy because in the fourth quarter of 2008 and the first quarter of 2009, real GDP decreased 6.3 percent and 5.5 percent, respectively. Further, in June 2010, the Treasury reported that banks had repaid about 75 percent of the bailout money they received through the Troubled Asset Relief Program, and that taxpayers made $21 billion on the investment. However, other bailouts are not yet repaid, and they may yield losses to taxpayers.

.08 From August 2009 to August 2010, the unemployment rate fluctuated between 9.5 percent and 10.1 percent. An unemployment rate of 10.0 percent represents approximately 15.3 million people. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. However, through the end of August 2010, the rate has remained below 10.0 percent. Additionally, one reason for the continued high unemployment rate is that more Americans are resuming their search for work.

.09 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points to less than 0.25 percent, where it remained through September 2010. The Federal Reserve described the current economic recovery in its September 21, 2010, press release as follows:

- Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software is rising, though less rapidly than earlier in the year, and investment in nonresidential structures continues to be weak.
- Employers remain reluctant to add to payrolls.
- Housing starts are at a depressed level.
- Bank lending has continued to contract, but at a reduced rate in recent months.
- The pace of economic recovery is likely to be modest in the near term.

.10 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant its holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the beginning of the financial market turmoil in August 2007, total assets on the Federal Reserve's balance sheet have grown from $869 billion to $2.3 trillion. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

Investment Companies Industry Trends and Conditions

State of the Investment Company Industry

.11 The state of the investment company industry remains consistent with the overall state of the economy. Although the environment is not as shaky as it was during the midst of the financial crisis, the road to recovery is rocky, and some investors appear to be losing their appetite for risk.

.12 From January 2010 to August 2010, long-term stock market mutual funds experienced a net new cash outflow of $18.2 billion, according to the Investment Company Institute (ICI). Instead, investors are choosing

safer investments such as bonds; the same time period had a net new cash inflow of $216.1 billion in long-term bond mutual funds (taxable and municipal). Further, long-term hybrid mutual funds experienced a net new cash inflow of $12.0 billion and money market funds experienced a net new cash outflow of $496.4 billion during the same eight months. When compared with year-to-date August 2009, all of these types of funds experienced an increase in net new cash flow, except for stock mutual funds and municipal bond mutual funds. Typically, following a recession, investors become bullish on stocks with the hope of profiting from a stock market recovery. However, even as corporate earnings have improved, investors have not rushed back into domestic stocks or domestic stock market funds. It is possible the notions in which investors historically believed—the stock market provides a safe and profitable investment, home values will always rise—have been upset by the recent financial crisis.

.13 Individual investors have become increasingly important over the past several decades as company-funded pensions have given way to individually managed 401(k) accounts for retirement. According to Hewitt Associates, a human resources consulting firm, until two years ago, 70 percent of the money in 401(k) accounts that it tracks was invested in stock funds; by January of 2009, that amount had fallen to 49 percent, as investors pushed their portfolios toward bonds. In August 2010, 57 percent of the money in 401(k) accounts was invested in stock funds; however, the increase was primarily attributable to the rise in prices as opposed to a change in investment approach. Another important factor to consider in this change of approach is the aging of the baby-boomer generation. This will skew large amounts of investment away from riskier stock funds to more conservative bonds and bond funds; these investors are looking for guaranteed income during their later years. Another possible factor behind investment withdrawals might be the growing demand for cash among those unable to find a job or obtain a home-equity loan. Further, as reported by Fidelity Investments, during the second quarter of 2010, a record number of workers made hardship withdrawals from their retirement accounts; also, the number of workers borrowing from their accounts reached a ten-year high.

.14 According to the ICI, from January 2010 through August 2010, the total net assets of the nation's mutual funds decreased by $346.3 billion or 3.1 percent. Of this total decrease,

- stock funds' total net assets decreased $244.7 billion (-4.9 percent),
- hybrid funds' total net assets increased $12.6 billion (2.0 percent),
- taxable bond funds' total net assets increased $318.4 billion (18.2 percent),
- municipal bond funds' total net assets increased $56.2 billion (12.3 percent),
- taxable money market funds' total net assets decreased $427.5 billion (-14.6 percent), and
- tax-free money market funds' total net assets decreased $61.3 billion (-15.4 percent).

Derivatives Related Disclosures

.15 In early 2010, the Securities and Exchange Commission (SEC) staff announced a review to evaluate the use of derivatives by mutual funds, exchange-traded funds (ETFs), and other investment companies. Until the review is complete, the staff has deferred consideration of exemptive requests under the Investment Company Act of 1940 (the 1940 Act) to permit ETFs that would make significant investments in derivatives. This decision affects both new and pending exemptive requests from certain actively managed and leveraged ETFs that particularly rely on swaps and other derivative instruments to achieve their investment objectives. This review will explore numerous issues related to the use of derivatives by funds, including the required derivatives-related disclosures by investment companies in registration statements and shareholder reports. Although the review was not completed at the time of this writing, in July 2010, the SEC sent a letter to the ICI with some of its observations that may give investment companies immediate guidance on ways to provide investors with more understandable disclosures related to derivatives, including the risks associated with them.

.16 The letter highlighted the following observations made by the SEC staff thus far in its study:

- Form N-1A (prospectus) derivatives disclosures could be improved because some funds provided generic disclosures that may be of limited usefulness for investors.

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- The Management's Discussion of Fund Performance (MDFP) section of mutual funds' annual report to shareholders, which is intended to provide shareholders with information about the factors that materially affected the fund's performance during its most recently completed fiscal year, did not consistently reflect material effects of derivatives on performance.
- Some funds could improve on the qualitative disclosures on the objectives and strategies regarding the use of derivatives required by Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 815, *Derivatives and Hedging*, in addition to other areas.

.17 On Form N-1A, the generic disclosures about derivatives had limited usefulness in evaluating the anticipated investment operations of the fund, because they lacked detail concerning how the fund's investment adviser actually intends to manage the fund's portfolio and the consequent risks. These generic disclosures took the form of either highly abbreviated disclosures with little or no explanation of the nature of the investments or, alternatively, highly technical disclosures (that is, not plain English) that provided no context to the fund's actual investment operations. Investors may not be able to distinguish which, if any, derivatives are part of the principal investment strategies of the fund or specific risk exposures they will entail. Further, they may be misled to believe a fund's exposure to derivatives is minimal due to abbreviated disclosures, when the fund actually has substantial investments in and exposure to derivatives. The opposite is also possible—that is, investors may be led to overestimate a fund's use of derivatives—when disclosures are lengthy and technical. Some fund complexes even provide the same derivatives-related disclosures for multiple funds that have significantly different exposure to derivatives. The SEC letter states that " . . . all funds that use or intend to use derivative instruments should assess the accuracy and completeness of their disclosure, including whether the disclosure is presented in an understandable manner using plain English. Further, any principal investment strategies disclosure related to derivatives should be tailored specifically to how a fund expects to be managed and should address those strategies that the fund expects to be the most important means of achieving its objectives and that it anticipates will have a significant effect on its performance."

.18 The SEC staff noted that although some funds, based on their financial statements, appear to have significant derivatives exposure, their MDFPs include minimal or no discussion of the effect of those derivatives on the funds' performance. Another inconsistency noted is that some funds that had no MDFP derivatives-related disclosure, but they disclosed in their registration statements principal investment strategies that included the use of derivatives. Derivatives-related disclosures should also be made if they materially affected a fund's performance during the year—regardless of whether derivatives were held at the close of the fiscal year.

.19 Lastly, the SEC staff also noted that improvements could be made in the derivatives disclosures required by FASB ASC 815. The required qualitative disclosures could be improved by funds addressing the effect of their use of derivatives during the reporting period. The financial statements and notes should sufficiently inform shareholders how a fund actually used derivatives during the period to meet its objectives and strategies. For funds that sell protection through credit default swaps, consideration may be given to explaining the relevance of the disclosed credit spreads. Funds should also remember that identification of the counterparty is a material component of over-the-counter (OTC) derivatives and should be disclosed. The letter can be accessed at www.sec.gov/divisions/investment/guidance/ici073010.pdf. Additional comments on this issue are discussed in the "SEC Comments and Observations" section of this alert.

SEC Circuit Breaker Rules

.20 On May 6, 2010, a market disruption occurred whereby the DJIA rapidly fell almost 1,000 points. The reasons for the fall have yet to be confirmed. Approximately one month later, the SEC approved rules that will require the exchanges and the Financial Industry Regulatory Authority (FINRA) to pause trading for five minutes in certain individual stocks if the price moves 10 percent or more in either direction in a five minute period. The pause would only apply to stocks in the S&P 500 and would give the markets the opportunity to attract new trading interest in an affected stock, establish a reasonable market price, and resume trading in a fair and orderly fashion. These rules are in effect on a pilot basis through December 10, 2010. The pilot period will be used to make appropriate adjustments to the parameters or operations of the circuit breakers

based on experience, and the scope of the rules will be expanded to securities beyond the S&P 500 as soon as practicable. Additionally, the SEC is considering recalibrating marketwide circuit breaker rules that were already in effect in May 2010 but were not triggered during the May 6 minicrash. By the end of June, these circuit breakers had been set off twice—both times for erroneous trades.

.21 At the end of June 2010, the SEC published for public comment proposals by the national securities exchanges and FINRA to expand the program to include all stocks in the Russell 1000 Index and certain ETFs. The markets will continue to use the pilot period to make appropriate adjustments to the parameters or operations of the circuit breakers as warranted based on their experience. ICI commented on both proposals, and in both comment letters, it explained its strong support for expanding the current pilot program to include ETFs. The latter comment letter noted that, "Excluding ETFs from circuit breakers that contain the individual securities comprising the ETFs' baskets creates risks that ETFs could again suffer disproportionately during a market event similar to that of May 6, which risks far outweigh any perceived benefits of excluding such ETFs." Both letters can be accessed from http://ici.org/policy/comments/archives/2010.

Proposed Regulations on Cost Basis Reporting

.22 In December 2009, the IRS released proposed regulations on cost basis reporting through Regulation 101896-09. For cost basis reporting purposes, anyone with tax reporting responsibility is considered a broker (that is, both mutual funds and broker-dealers would be subject to the proposed regulations). The proposed regulations relate to

- reporting sales of securities by brokers and determining the basis of securities that reflect changes in the law made by the Energy Improvement and Extension Act of 2008 that requires brokers when reporting the sale of securities to the IRS to include the customer's adjusted basis in the sold securities and to classify any gain or loss as long-term or short-term
- how taxpayers compute their basis when averaging the basis of shares acquired at different prices and their expansion of liability in that computation which reflect changes in the law
- providing brokers and others until February 15 of each year to furnish certain information statements to customers
- new reporting requirements imposed upon persons that transfer custody of stock and upon issuers of stock regarding organizational actions that affect the basis of the issued stock
- how brokers report short sales of securities that reflect changes in the law

.23 The ICI has submitted two comment letters to the IRS on these proposed regulations because the regulations raised a number of implementation and calculation issues for brokers, including mutual funds. The following specific aspects of the proposed regulations were commented on and are considered to be most important to the mutual fund industry: (*a*) average cost, (*b*) gifted and inherited shares, (*c*) flexibility for transfer statements, and (*d*) the February 15 reporting deadline.

.24 Final regulations are expected to be issued by fall 2010, and there will be an 18-month window for implementation. The proposed regulations are expected to be effective for fund shares acquired after December 31, 2011, and effective for other equities acquired after December 31, 2010. Readers should be alert for the issuance of final regulations.

Trends in Fees and Expenses of Mutual Funds

.25 Of the five key findings discussed in the ICI paper, *Trends in the Fees and Expenses of Mutual Funds, 2009*, the only increases in fees or expenses were in the expense ratios of stock funds and bond funds, which were nominal at 2 basis points each. The other four key findings included fees and expenses incurred by investors in long-term mutual funds were unchanged; rising expense ratios of long-term funds were offset by a decline in load fee payments by investors; the average fees and expenses of money market funds fell 4 basis points; and average expense ratios of funds of funds declined for the fourth consecutive year. Between 1990 and 2009,

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the average fees and expenses paid by investors for stock funds, bond funds, and money market funds all decreased by at least 38 percent.

.26 Regarding stock funds, the increase in fund expense ratios is not unexpected given the recent market downturn—that is, when the assets of stock funds decline, the relatively fixed expenses of funds contribute proportionally more to the ratio. If stock funds continue to recover, the expectation is that fund expense ratios will decline. For bond funds, the nominal increase in the expense ratio was driven by fees paid by some tax-exempt funds that chose to establish and draw down on lines of credit from banks rather than sell securities into depressed markets to meet various capital needs. These commitment fees and interest costs added to the expenses of these funds, which increased the industrywide average. However, the tax-exempt bond funds that implemented this strategy were generally the best performing funds in their class during 2009.

.27 The drop of 4 basis points in the fees and expenses of money market funds was attributable both to a decline in expense ratios among individual funds and an increase in market share of institutional money market funds. Although both types of funds saw decreases in expense ratios, the decrease from the institutional money market funds had a stronger effect because those funds continue to gain market share (2/3 of the assets in all money market funds by the end of 2009) and, generally speaking, have lower expense ratios than retail money market funds. This is typically the case because retail funds have more investors with smaller average account balances.

.28 The two primary types of funds of funds are lifestyle and lifecycle. Lifestyle and lifecycle funds of funds account for 61 percent of the total number and 68 percent of the total assets of funds of funds. The decrease in expense ratios of funds of funds was nominal from 2008 to 2009, but the decrease between 2005 and 2009 was 10 basis points. This is equally attributable to a decrease in expense ratios of individual funds and an increase in market share of lower-cost funds and other factors.

Proposal for Mutual Funds That Invest in Futures Contracts to Register With the Commodity Futures Trading Commission

.29 In June 2010, the National Futures Association (NFA) proposed that commodities funds that invest in futures contracts register with not only the SEC but also the Commodity Futures Trading Commission (CFTC). *Futures contracts* are leveraged derivatives whose value is linked to the future value of markets from commodities to interest rates. The NFA is an industry-funded watchdog for futures investors that had this power until 2003; the underlying rationale for the funds to be dually registered is that it would help boost disclosure to investors about what these funds invest in and make fees and costs more readily apparent. However, it will not change what the funds can buy, nor will it alter the recourse investors have if things go awry. Some concerns that have been voiced relate to the additional burden in terms of compliance work and costs, the different regulatory framework of the CFTC as compared with the SEC, delays in the fund registration process, and increased confusion of two regulators. As of this writing, the CFTC has not identified a timeline for action.

Legislative and Regulatory Developments

The Dodd-Frank Wall Street Reform and Consumer Protection Act

.30 On July 21, 2010, the president signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) into law in response to weaknesses in the financial services industry that are believed to have contributed to the recent recession. The Dodd-Frank Act was approved by the House on June 30, before narrowly clearing the Senate on July 15. As the economy is slowly recovering from the worst economic downturn since the Great Depression, this reform represents the greatest change to financial regulation since that time. It ends the era of hands-off regulation and increased deregulation of the financial services industry. The two main goals of the reform are to lower the systemic risks to the financial system and to enhance consumer protections.

.31 The Dodd-Frank Act, among many other changes, will create new regulations for companies that extend credit to customers, exempt small public companies from Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX), make auditors of broker-dealers subject to Public Company Accounting Oversight Board (PCAOB) oversight, and change the registration requirements for investment advisers. It mandates more than 60 different studies and reports by various oversight agencies on a range of issues. Because these new regulations will most likely be produced over the next few years, the impact of these reforms will be staggered. This will provide opportunities for the financial services industry to respond to the proposed regulations and work with regulators in developing reporting requirements, formats, and timetables that are practical to implement. Additionally, this will enable both regulators and the industry to meet their individual goals, which is important to the efforts to avoid market disruptions and inadvertently increase systemic risk. Large, complex institutions, in particular, and newly regulated entities with new reporting requirements will be challenged to update their systems and data infrastructures. Although the Dodd-Frank Act contains many provisions, some highlights that may be of particular interest to auditors are summarized in the following sections.

Financial Stability Oversight Council

.32 The Dodd-Frank Act creates a new systemic risk regulator called the Financial Stability Oversight Council (FSOC). The two main goals of the FSOC are to identify risks to the financial stability of the United States and promote market discipline by eliminating the expectation of "too big to fail." To meet these goals, the FSOC has many powers, and it will identify any company, product, or activity that could threaten U.S. financial stability. The FSOC has the power to designate nonbank financial entities as systemically important and, through the Office of Financial Research (OFR), may collect reports from any bank holding entity or nonbank financial entity for the purpose of determining whether it poses a threat to U.S. financial stability. These entities will be under the supervision of the Federal Reserve. Foreign nonbank financial entities may also be identified for heightened supervision and regulation. The new OFR is targeted to be established and fully operational no later than one year after enactment. The FSOC will be chaired by the Secretary of the Treasury, and members will be heads of regulatory agencies, including the chairmen of the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the SEC, among others. The first meeting of the FSOC will be in October 2010. For those large entities deemed a threat to U.S. financial stability, the FSOC can, under the authority of a new orderly liquidation authority, authorize the FDIC to close such entities. Upon enactment of the Dodd-Frank Act, the FSOC, through the Federal Reserve, will also have the power to preemptively require a large, complex entity to divest some of its holdings if it poses a grave threat to the stability of the United States, although this is intended only as a last resort.

.33 The FSOC will make recommendations to the Federal Reserve to impose increasingly stringent capital, leverage, liquidity, risk management, and other requirements as entities grow in size and complexity, with significant requirements for entities that pose a risk to the financial system. These standards must include risk-based capital requirements and leverage limits, unless the Federal Reserve, in consultation with the FSOC, determines that such requirements are not appropriate for an identified nonbank firm "because of the activities of such entity (such as investment company activities or assets under management) or structure, in which case the [Federal Reserve] should apply other standards that result in similarly stringent risk controls." Final rules must be made by the Federal Reserve no later than 18 months after enactment. The current level of minimum leverage capital requirements is to be the floor for the future capital requirements to be developed.

.34 Financial entities will be required to conduct "stress tests" (as defined by the primary regulators). For bank holding companies with total consolidated assets of at least $50 billion and identified nonbank firms, the testing will be done semiannually; annual testing will be required of other financial entities that have total consolidated assets exceeding $10 billion and are regulated by a primary federal financial regulatory agency.

.35 New and stricter capital requirements will have differing effects on financial entities. Some may move toward lower-margin businesses that are less capital intensive, but others may continue to strive for higher returns. Further, new forms of capital, such as contingent capital, may be considered a possibility. This capital would effectively be subordinated, and other forms of debt that convert to common equity under prescribed

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conditions may be considered. Low interest rates and government support have helped many entities build up their capital. Some rating agencies have said that without this assistance, many entities would have lower credit ratings, and as the new rules are implemented, some may experience downgrades. Entities will likely be considering new ways to build and maintain capital or shed troubled assets. The FSOC has the ability to veto rules created by another new regulator, the Bureau of Consumer Financial Protection (BCFP), with a two-thirds vote.

Bureau of Consumer Financial Protection

.36 The new BCFP consolidates most federal regulation of financial services offered to consumers. The director of the BCFP replaces the director of the Office of Thrift Supervision (OTS) on the FDIC board. Almost all credit providers, including mortgage lenders, providers of payday loans, refund anticipation loan providers, other nonbank financial companies, and banks and credit unions with assets over $10 billion, will be subject to the new regulations. The BCFP has no authority to exercise any power to enforce the legislation with respect to SEC-regulated persons. This exclusion specifically applies to registered investment companies, registered investment advisers, registered broker-dealers, and registered transfer agents, among others. Also excluded from the BCFP's jurisdiction are 401(k) and other retirement plans.

.37 The BCFP has the authority to examine and enforce regulations for banks and credit unions with assets of over $10 billion and all mortgage-related businesses (lenders, servicers, and mortgage brokers, including regulations to crack down on foreclosure scam operators), providers of payday loans, and student lenders, as well as other nonbank financial entities that are large, such as debt collectors and consumer reporting agencies. Banks and credit unions with assets of $10 billion or less will be examined for consumer compliance by the appropriate regulator. The BCFP also is able to autonomously write rules for consumer protections governing all financial institutions (banks and nonbanks) offering consumer financial services or products.

.38 The Dodd-Frank Act recognizes that CPAs providing customary and usual accounting activities (which include accounting, tax, advisory, or other services that are subject to the regulatory authority of a state board of accountancy), and other services incidental to such customary and usual accounting activities are already adequately regulated and, therefore, are not subject to the BCFP's authority.

.39 A national consumer complaint hotline will be created so that consumers will have, for the first time, a single toll-free number to report problems with financial products and services. Functions currently handled by existing agencies are expected to be transferred to the BCFP, and the BCFP is expected to assume full authority for consumer financial protection no later than one year after enactment.

Ending "Too Big to Fail" Bailouts

.40 The Dodd-Frank Act is intended to reduce the risk that large firms will take excessive risk because they believe they are, in effect, guaranteed to be bailed out in the event of failure. Bailouts like this occurred during the recent economic recession. Although that is one intent of the specific changes required by this reform, whether that goal will be achieved can only be determined over time. The desired result is that taxpayers will not again be responsible to save a failing financial entity or cover the cost of its liquidation.

.41 Under the Dodd-Frank Act's new so-called Volcker Rule, a banking entity will be restricted in its proprietary trading; will be prohibited from acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and be prohibited from sponsoring a hedge fund or private equity fund. The term *sponsor* when used with respect to a hedge fund or private equity fund includes an entity

- serving as a general partner, managing member, or trustee of the fund;
- selecting or controlling a majority of the directors, trustees, or management of the fund; and
- sharing the same name (or a variation of the same name) with the fund for corporate, marketing, promotional, or other purposes.

.42 Final rulemaking on the Volcker Rule must be no later than nine months after the FSOC's recommendations on implementation considerations. *Proprietary trading* consists of transactions made by an entity that affect the entity's own account but not the accounts of its clients; that is, the entity is using its own money to place directional market bets that are unrelated to serving customers. Some of the benefits to bank entities of proprietary trading, which will now be restricted, include the following:

- Allows the entity to profit on its own instead of collecting commissions and fees from clients
- Allows the entity to build an inventory of securities, which can be useful if a client places a trade in an illiquid market
- Allows the bank to make a market when it is assigned to ensure the liquidity for a given security

.43 A major bank estimated that 10 percent of its revenue came from proprietary trading, but that figure may vary depending on the size and complexity of the institution. There are limited exceptions to the restrictions on proprietary trading, such as transactions in government securities, agency securities, and state and municipal obligations; certain risk-mitigating hedging activities on behalf of the covered banking entity; transactions on behalf of customers; the sale or securitization of loans in a manner otherwise permitted by law; and investments in small business investment companies and other entities devoted to the public interest. Banks are allowed to make *de minimis* investments in hedge funds and private equity funds, using no more than 3 percent of their tangible common equity in all such funds combined. Also, a bank's investment in a private fund may not exceed 3 percent of the fund's total ownership interest. Nonbank financial institutions supervised by the Federal Reserve will also have restrictions on proprietary trading, hedge fund investments, and private equity investments.

.44 The Dodd-Frank Act also requires large, complex financial entities to periodically submit plans for their rapid and orderly shutdown should the company go under (a "funeral plan" or "living will"). No later than 18 months after enactment, the Federal Reserve Board and the FDIC must issue final rules implementing the resolution plan requirement. Entities that fail to submit acceptable plans will have higher capital requirements and restrictions on growth and activity, as well as divestment. This will create an increased focus on entity-level financial and operational concerns for these large, complex entities.

.45 Additionally, an orderly liquidation mechanism for the FDIC to unwind failing systemically significant financial entities that pose a risk to the financial system has been created. The mechanism provides that shareholders and unsecured creditors bear losses and management and culpable directors will be removed. The FDIC will only be allowed to borrow funds to liquidate an entity when it expects to be repaid from the assets of the entity being liquidated, and the government will be first in line for repayment. Funds that are not repaid from the sales of the entity's assets will be repaid first through the clawback of any payments to creditors that exceeded liquidation value and then through assessments on large financial entities (with the riskiest ones paying more). Taxpayers will bear no cost for liquidations, and the Federal Reserve will no longer be able to provide "open institution" assistance by making emergency "bail-out" loans to it. Consistent with the treatment of financial contracts in a resolution by the FDIC of an insured depository institution, the Dodd-Frank Act allows for a delay of up to one business day in the enforcement of "qualified financial contracts," including repurchase agreements. To prevent bank runs, the FDIC can guarantee debt of solvent insured banks, but only after meeting serious requirements.

Sarbanes-Oxley Section 404(b) Exemption

.46 The Dodd-Frank Act amends SOX to make permanent the exemption from its Section 404(b) requirement for nonaccelerated filers (those with less than $75 million in market capitalization) that had temporarily been in effect by order of the SEC. Section 404(b) of SOX requires companies to obtain an auditor's report on management's assessment of the effectiveness of the company's internal control over financial reporting. In September 2010, the SEC issued Final Rule Release Nos. 33-9142; 34-62914, *Internal Control Over Financial Reporting in Exchange Act Periodic Reports of Non-Accelerated Filers*, to conform its rules to this resulting change from the Dodd-Frank Act.

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.47 The Dodd-Frank Act also requires the SEC to complete a study within 9 months of the act's enactment on how to reduce the burden of Section 404(b) SOX compliance for companies with market capitalizations between $75 million and $250 million. The study will consider whether any such methods of reducing the burden, or a complete exemption, would encourage companies to list on U.S. exchanges.

Auditors of Broker-Dealers

.48 The Dodd-Frank Act also provides for the PCAOB to create a program for registering and inspecting the auditors of broker-dealers, including standard setting and enforcement. Currently, all auditors of broker-dealers must be registered with the PCAOB. The Dodd-Frank Act allows the PCAOB, in its inspection rule, to differentiate among broker-dealer classes and to potentially exempt introducing brokers, such as those who do not engage in clearing, carrying, or custody of client assets.

.49 The SEC published Interpretation Release No. 34-62991, *Commission Guidance Regarding Auditing, Attestation, and Related Professional Practice Standards Related to Brokers and Dealers*, to clarify the application of certain SEC rules, regulations, releases, and staff bulletins in light of the previously referenced authority granted to the PCAOB in the Dodd-Frank Act. The SEC is considering a rulemaking project to update the audit and related attestation requirements under the federal securities laws for brokers and dealers, particularly in light of the Dodd-Frank Act.

.50 In addition, the PCAOB has not yet revised its rules, which currently refer only to issuers, to require registered public accounting firms to comply with PCAOB standards for audits of nonissuer brokers and dealers. As a result, the SEC is providing transitional guidance with respect to its existing rules regarding nonissuer brokers and dealers. Specifically, references in SEC rules and staff guidance and in the federal securities laws to generally accepted auditing standards (GAAS) or to specific standards under GAAS, as they relate to nonissuer brokers or dealers, should continue to be understood to mean auditing standards generally accepted in the United States, plus any applicable rules of the SEC. The SEC intends to revisit this interpretation in connection with its rulemaking project referenced previously.

Derivatives Trading

.51 The Dodd-Frank Act provides the SEC and the CFTC with the authority to regulate OTC derivatives and requires central clearing and exchange trading for derivatives that can be cleared. The SEC will have authority over security-based swaps (including credit default swaps). The CFTC will have authority over all other swaps, including energy-rate swaps, interest-rate swaps, and broad-based security group or index swaps. Standardized swaps will be traded on an exchange or in other centralized trading facilities, which will promote transparency; standardized derivatives will also have to be handled by central clearinghouses. *Cleared* describes when trades are routed through a central clearinghouse that covers losses if a party to the trade is unable to complete the transaction. As a safeguard, many derivative traders will also be required to post margin to ensure all obligations can be paid and to offset the general risks that derivative trading poses to the financial system. Clearing and exchange trading requirements are expected to become effective 360 days following enactment. The Dodd-Frank Act prohibits "federal assistance," including federal deposit insurance and access to the Federal Reserve discount window, for any "swaps entity" with respect to any swap or security-based swap or other activity of the swaps entity.

.52 The Dodd-Frank Act also provides regulators with the authority to impose capital and margin requirements on swap dealers and major swap participants, not end users. Rules prescribed by the CFTC or the SEC must be promulgated no later than 360 days after enactment. By making the market more transparent, the pricing of common kinds of derivatives from the open marketplace may be reduced and would allow a wider range of entities to hedge their risks; customized derivatives could still have higher prices. The credit exposure from derivative transactions will be added to banks' lending limits. However, the new rules may increase some costs of derivative trading because the increased transparency and price competition between securities dealers, may reduce dealer profit margins, causing them to charge a higher trading fee. Banks are allowed to continue engaging in principal transactions involving interest-rate, foreign-exchange, gold, silver, and investment-grade credit default swaps, subject to Volcker Rule limitations on proprietary trading. For

commodities, most other metals, energy, and equities, banks will have to shift their swap operations to a separately capitalized affiliate within the holding entity. Under an end user exemption, nonfinancial firms can still use derivatives to hedge and manage the commercial risks associated with their businesses.

Accounting Standards

.53 The Dodd-Frank Act gives the FSOC the duty to monitor domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and to advise Congress to make recommendations in such areas that will enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets. The FSOC may submit comments to the SEC and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure.

Credit Rating Agencies

.54 Section 939A of the Dodd-Frank Act requires federal agencies to review regulations that require an assessment of the credit-worthiness of a security or money market instrument and contains references to or requirements regarding credit ratings. In addition, the agencies are required to remove such references and substitute in their place uniform standards of credit-worthiness, when feasible.

.55 In August 2010, the SEC issued a no-action letter to ICI discussing the effect this requirement of the Dodd-Frank Act would have on the February 2010 amendments to Rule 2a-7 of the 1940 Act. Specifically, the amendments to Rule 2a-7 require boards of directors of money market funds to designate at least four nationally recognized statistical rating organizations (NRSROs) whose ratings the fund would use to determine the eligibility of portfolio securities under the rule. These NRSROs would likely need to be designated by the fall of 2010 by the boards of directors to meet the December 31, 2010, compliance date. The effect of Section 939A would be to render boards' determinations made this fall irrelevant several months later when the SEC is required to eliminate the relevant references to credit ratings. The no-action letter explains that the Division of Investment Management would not recommend that the SEC institute an enforcement action under Section 2(a)(41) of the 1940 Act and Rule 2a-4 and Rule 22c-1 thereunder if a money market fund board does not designate NRSROs and does not make related disclosures in its statement of additional information before the SEC has completed the review of Rule 2a-7 required by the Dodd-Frank Act and has made any modifications to the rule. Until the SEC determines to modify Rule 2a-7 in accordance with Section 939A of the Dodd-Frank Act, money market funds relying on this letter must continue to comply with the obligations for determining and monitoring eligible securities set forth in Rule 2a-7 as in effect before May 5, 2010 (other than the limitation on holding unrated asset backed securities rescinded by the 2010 rulemaking). The no-action letter can be accessed at http://sec.gov/divisions/investment/noaction/2010/ici-nrsro081910.htm.

Registered Investment Advisers and Hedge Funds

.56 Currently, the Investment Advisers Act of 1940 requires investment advisers with more than $30 million in assets under management to register with the SEC. Under the new reform, this threshold for federal registration will be raised to $100 million, with certain exceptions. This change will increase the number of small advisers under state supervision and allow the SEC to focus on newly registered hedge fund advisers. Advisers will provide information about their trades and portfolios necessary to assess their systemic risk. The exemption in the Investment Advisers Act of 1940 for advisers with fewer than fifteen clients has also been eliminated. Although that exemption has been eliminated, the Dodd-Frank Act will create several new exemptions from the registration requirements for advisers to private funds. These exemptions will be for midsized private fund advisers (those with assets under management in the United States of less than $150 million), venture capital fund advisers (to be defined by the SEC), foreign private advisers, family offices (to be defined by the SEC), commodity trading advisers, small business investment companies, and intrastate advisers. The new registration requirements will become effective one year after enactment; however, any investment adviser may, at the discretion of the investment adviser, register with the SEC during that one-year period.

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.57 The Dodd-Frank Act gives the SEC authority to require registered investment advisers to maintain such records, and file such reports, regarding private funds advised by the adviser as necessary and appropriate in the public interest and for the protection of investors or, notably, for the assessment of systemic risk by the FSOC. The required records and reports that the SEC has the authority to require for each private fund include a description of the amount of assets under management (AUM) and use of leverage, counterparty credit risk exposures, trading and investment positions, valuation policies and practices of the fund, types of assets held, side arrangements or side letters, trading practices, and such other information as the SEC in consultation with the FSOC determines necessary or appropriate in the public interest. This may include the establishment of different reporting requirements for different classes of fund advisers based on the type or size of the private fund being advised. These potential additional disclosure requirements will likely facilitate additional SEC scrutiny of potential conflicts of interest, investor disclosures, and valuation matters. These possible requirements are still subject to the final rule making by the SEC.

.58 Investment advisers, now including those advising hedge funds, must take steps to safeguard client assets over which such adviser has custody, including, without limitation, verification of such assets by an independent public accountant, as the commission may, by rule, prescribe. The Dodd-Frank Act also raises the standard for individuals to qualify as accredited investors, a basic threshold for purchasing private investments; these investors must now have $1 million, excluding the value of their primary residence. This amount will be adjusted for inflation. The prior standard was simply $1 million.

SEC and Investor Protections

.59 Because it lowers the legal standard from "knowing" to "knowing or reckless," the Dodd-Frank Act may make it easier for the SEC to prosecute aiders and abettors of those who commit securities fraud under the Securities Act of 1933, the Securities Exchange Act of 1934, the 1940 Act, and the Investment Advisers Act of 1940. This change will increase the difficulty for a defendant to fight a civil enforcement action because the SEC no longer has to show that the person intended to aid another person's violation. It only must demonstrate that the defendant's reckless conduct furthered the violation. The SEC and the Department of Justice will also now have the authority to bring civil or criminal law enforcement proceedings involving transnational or extraterritorial securities frauds. Additionally, the Dodd-Frank Act authorizes two studies on these matters. One of the studies directs the Government Accountability Office to investigate the impact of authorizing private rights of action for aiding and abetting claims and to release its findings within one year. The second study directs the SEC to examine whether private rights of action should be authorized for transnational or extraterritorial claims and is to be completed within 18 months.

.60 The Dodd-Frank Act gives the SEC the authority to impose a fiduciary duty on brokers who give investment advice (that is, the advice must be in the best interest of their customers—currently, this applies to investment advisers). Currently, brokers are only required to recommend investments that are suitable for customers. The SEC must first study this issue and deliver a report to Congress on the costs and benefits. The Office of the Investor Advocate (OIA) will also be created within the SEC to identify areas in which investors have significant problems dealing with the SEC and to provide investors with assistance. Another responsibility of this office will be to identify areas in which investors would benefit from changes in SEC regulations. The OIA must submit its first annual report to Congress no later than June 30, 2011.

.61 A whistle-blower program, with rewards to encourage securities violations reports, was created by the Dodd-Frank Act. An exception is provided for any whistle-blower who gains information through the performance of an audit of financial statements. Employers are prohibited from retaliating against whistle-blowers. Subsidiaries and affiliates that are consolidated with public companies for financial accounting purposes will become subject to the whistle-blower protections in SOX.

.62 The SEC is permitted to use fee collections to establish a reserve fund of up to $100 million that can be used to fund special projects. The SEC may submit its annual budget directly to Congress without requiring the prior approval of the White House. The SEC has publicly stated that it will need to hire approximately 800 additional people to carry out the new reforms (given the new required enforcement, the five offices created within the SEC, and the studies to be carried out) and to develop the specifics of new regulations.

Executive Compensation

.63 The Dodd-Frank Act requires a nonbinding shareholder vote on executive pay and golden parachutes for public companies. Although the vote is nonbinding, a "no" vote by shareholders would likely force management to respond in some way and can still have a beneficial effect. Every institutional investment manager will be required to disclose these advisory votes, unless (as with registered investment companies) they are already required to disclose such votes. Broker discretionary voting in uncontested director elections for all listed entities except for registered investment companies is prohibited. Consistent with current New York Stock Exchange rules, discretionary broker voting in uncontested director elections for registered investment companies is permitted. At a public company's first shareholder meeting following the end of the six month period after enactment, management must give shareholders the opportunity to vote on how frequently shareholders will have a "say on pay" (that is, annually, every two years, or every three years).

.64 The SEC now has the authority to grant shareholders proxy access to nominate directors, which is intended to help shift management's focus from short-term profits to long-term growth and stability. However, shareholders would need to exercise this right for it to have any possibility of an impact. The SEC is allowed to exempt small businesses from this requirement. The SEC issued the final proxy access rule, Final Rule Release No. 33-9136, *Facilitating Shareholder Director Nominations*, in August 2010. The rule will facilitate the effective exercise of shareholders' traditional state law rights to nominate and elect directors to company board of directors. The new rules will require, under certain circumstances, a company's proxy materials to provide shareholders with information about, and the ability to vote for, a shareholder's, or group of shareholders', nominees for director. The Dodd-Frank Act also requires entities to disclose in their annual proxy statement the median of annual total compensation to all employees, other than their CEO; the annual total compensation of the CEO; and the ratio of these two amounts. Disclosure is also required regarding why the chairman of the board and CEO positions are separate or combined.

.65 Federally regulated financial institutions with more than $1 billion in assets will be required to disclose incentive-based compensation arrangements to their federal regulator. The federal financial regulators, jointly, will prohibit any types of incentive-based compensation arrangement that they determine encourage inappropriate risks by covered financial institutions. Issuers, including registered investment companies, will be required to disclose whether employees or directors may hedge or offset any decrease in the market value of equity securities they hold in the entity.

.66 Compensation based on financial statements that are restated must be returned for the three years preceding the restatement in an amount equal to the excess of what would have been paid under the restated results. This is required regardless of whether the executive was involved in the misconduct that led to the restatement. The SEC will require the national securities listing exchanges to enforce the compensation policies. This provision should not affect registered investment companies as issuers. The Dodd-Frank Act also requires directors of compensation committees to be independent of the entity (*independent* as defined by its exchange) and its management. The members of that committee are required to select consultants, legal counsel, and other advisers only after taking into account independence factors established by the SEC. The SEC will write these rules, which are required to be final no later than 360 days after enactment. New disclosures regarding compensation will also be required, such as the incentive-based compensation policies. Further, the SEC is required to clarify disclosures on compensation, including requirements to provide information that shows the relationship between executive compensation actually paid and the financial performance of the issuer.

.67 Overall, the level and complexity of the relationships that entities have with their regulators will increase because of the passage of the Dodd-Frank Act. Already, many firms have chief risk officers who sit above any risk management structures inside business units and try to manage the firm's overall risk profile. This position is important because it creates a single senior point of contact for regulators seeking a high-level understanding of where a firm may have risk concentrations with possible systemic implications. Entities that do not have this position will likely reconsider the creation of one.

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Other Requirements and Additional Information

.68 The OTS, which is currently the regulator for savings-and-loan financial institutions, will be abolished under the Dodd-Frank Act. Under the Dodd-Frank Act, such institutions will now be regulated by the Office of the Comptroller of the Currency, which also regulates federally chartered banks. A copy of the full Dodd-Frank Act, as signed by the president, can be found at www.gpo.gov/fdsys/pkg/BILLS-111hr4173ENR/pdf/ BILLS-111hr4173ENR.pdf. The AICPA is also following any developments related to the Dodd-Frank Act on our website at www.aicpa.org under "Advocacy—Federal Issues."

SEC Comments and Observations

Disclaimer: The following comments represent the views of the accounting staff of the SEC's Division of Investment Management and do not necessarily reflect the views of the commission or other members on the commission's staff. These comments were compiled by the AICPA Investment Companies Expert Panel and have not been approved or endorsed by the SEC or its staff. This is not intended to be a comprehensive list.

General

.69 The SEC staff encourages consultation on unique or difficult accounting and reporting issues. To facilitate the consultation process, the SEC has a dedicated e-mail address (imoca@sec.gov) and a dedicated phone number (202-551-6918).

.70 Section 408 of SOX requires the SEC to review financial statements of all registrants at least once every three years. For investment companies, the review process is performed by a dedicated group in the Division of Investment Management, who review the financial statements of an entire complex. The staff will also take the opportunity to review related financial statements when a Form N-14 related to business combinations is filed. Often, for investment companies, staff comments are provided verbally to either an internal or external attorney representing the fund organization; the staff encourages accountants within fund organizations to participate in those conversations, as direct communication avoids misunderstandings about accounting-related comments.

Consolidation and Investees

.71 Rule 6-03(c) of Regulation S-X states that "[financial] statements of [an investment company] may be consolidated only with [financial] statements of subsidiaries which are investment companies." However, the SEC staff has not objected to consolidation of noninvestment company subsidiaries in certain cases (see letters to Fidelity Select Portfolio, April 29, 2008, and NGP Capital Resources Company, December 28, 2007). The staff has recently become aware of certain special purpose vehicles (SPVs) that typically would be consolidated under FASB ASC 810, *Consolidation*, but have not been consolidated based on Rule 6-03(c). The staff encourages registrants to consider the substance as well as the form of the relationship between the investment company and SPVs and whether consolidation more appropriately reflects overall financial position and results of operations.

.72 The staff has also observed an increase in the number of registrants making significant investments in nonregistered investment companies. The staff has requested, if the registered investment company's investment in the nonregistered investment company exceeds 25 percent of the fund's net assets, inclusion of the nonregistered company's financial statements as part of the registered investment company's shareholder report. Further, the nonregistered company's financial statements would be required to meet the form and content requirements of Regulation S-X, including a Schedule of Investments to the same level of detail as for the registered investment company itself (that is, both presenting either complete schedules of investments in the shareholder report under Rule 12-12 of Regulation S-X, or condensed schedules under Rule 12-12C of Regulation S-X in the shareholder report together with complete schedules in the registered company's Form N-CSR filing).

Fair Valuation

.73 The volume of changes and updates in FASB's fair valuation standards (FASB ASC 820, *Fair Value Measurements and Disclosures*) has resulted in differing levels of disclosure of valuation policies, including inputs and assumptions, among fund complexes. The SEC staff noted that FASB's intent is for the granularity of disclosure to increase as the valuations increasingly become based on less observable factors.

.74 The staff has received questions on the effective dates of the additional disclosures on transfers adopted as part of Accounting Standards Update (ASU) No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. The stated effectiveness is for fiscal years and interim periods beginning after December 15, 2009. The staff observed that this reporting convention is similar to that provided in FASB Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*, and should be understood in a similar manner, as requiring adoption for any interim period beginning after December 15, 2009, including the final interim period for the year. Thus, for example, a fund with a fiscal year-end of November 30, 2010, would adopt the standard for its Form N-Q filing for the quarter ended August 31, 2010, as well as its November 30, 2010, annual report, because the final six months of the year represent an interim period beginning after December 15, 2009.

.75 The recent FASB financial instruments exposure draft, which would require investment companies to report all liabilities, including term debt, at fair value, had raised questions about whether fair value or contractual amounts outstanding would be used to calculate asset coverage under Section 18 of the 1940 Act. The staff expressed its view that these tests should be calculated based on the contractual amounts outstanding.

Derivatives

.76 In relation to the July 30, 2010, letter issued to the ICI (http://sec.gov/divisions/investment/guidance/ici073010.pdf) on the disclosure of derivatives in prospectuses and shareholder reports, the staff made the following comments. The staff observed that both the letter and the following comments were not intended to impose requirements in addition to those in FASB ASC 815, Regulation S-X, or Form N-1A, but rather to enhance transparency of disclosure to shareholders and provide enough information to assist investors in understanding the extent, risks of, and reasons for derivatives use.

- The staff reminded registrants that Form N-1A requires registrants to identify, among other things, how the fund intends to achieve its investment objectives by identifying the fund's principal investment strategies (including the type or types of securities in which the fund invests or will invest principally). The staff also reminded registrants that for non–money market funds, Form N-1A requires MDFP to discuss factors that materially affected the fund's performance during the most recently completed fiscal year, including the relevant market conditions and the investment strategies and techniques used by the fund's investment adviser.
- Prospectus disclosures should be written in "plain English" and provide meaningful disclosure of the reasons for and intended use of derivatives (for example, hedging, speculation, and substitute for conventional securities) and related risks, as required by Items 4 and 9 of Form N-1A. Prospectus disclosures should also provide enough information so that shareholders can understand the extent to which derivatives are expected to be used. The staff indicated that registrants are not expected to disclose a percentage to convey extent; however, registrants should provide some disclosure of anticipated exposure. Disclosures contained in the prospectus should be tailored to include the derivative types that represent "principal investment strategies of the Fund," with the full list of derivatives which may be used appearing in the statement of additional information. The staff reminded registrants that if a fund changes its investment strategy during the year to invest in derivatives, the fund can "sticker" its prospectus to meet its disclosure obligations of informing shareholders of principal investment strategies. Risk disclosures in the prospectus should provide shareholders with a complete risk profile of the fund's investments taken as a whole and should be adequately tailored based on anticipated derivatives usage as opposed to being a list of risks of all types of derivatives strategies the fund "may" employ. In reviewing prospectuses as part of the

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derivatives study, the staff compared prospectus disclosures to historical usage as presented in the prior two to three years of financial statements to identify those strategies which appeared to be "principal" strategies as opposed to those which were infrequently employed. The staff observed that in certain cases, many funds in a fund family had the same derivative disclosures in their prospectuses despite significantly differing levels of derivative usage (for example, the same disclosures were made for funds in the fund family which used derivatives extensively and for other funds in the same fund family which did not use derivatives).

- The staff reminded registrants that when they update their registration statements, they should determine whether any prospectus disclosures need to be revised based on derivative usage in the financial statements and anticipated derivatives usage.
- The discussion of derivatives' effect on the fund's performance contained in MDFP should be tailored to the derivatives usage reported in the statement of operations, with adequate discussion of the effect on return (positive or negative), if material. The staff observed in its financial statement reviews that in certain cases MDFP did not discuss the impact of derivatives on performance even when the funds used derivatives as a principal investment strategy and derivatives had a material impact on performance. The staff also observed instances in which derivatives had a material impact on performance but the MDFP contained forward looking disclosure regarding derivative use and did not discuss the impact of derivatives on performance (for example, MDFP indicated the fund may achieve exposures to issuers, interest rates, and currencies through investments in derivatives but did not discuss the impact of derivatives on performance).
- The staff continues to remind registrants that financial statement disclosure required by FASB ASC 815-10-50-1A of how and why funds use derivatives during the reporting period should be tailored to the actual reasons for derivative use, rather than reciting the reasons for why derivatives "may" be used or copying prospectus disclosure. The staff encourages financial statement preparers to discuss the reasons for derivatives use with portfolio managers to enhance the disclosure's relevance. Additionally, the staff observed that footnotes within a fund complex should be tailored to the actual extent of derivatives usage by individual funds, rather than using identical disclosure for all funds regardless of the level of activity.
- Disclosure of the volume of derivatives use, as required by FASB ASC 815-10-50-1A, should be presented in a manner which is meaningful to shareholders. The staff noted that there is flexibility in how to disclose the volume of use and encouraged registrants to leverage other information in the financial statements, where appropriate. It is acceptable, where appropriate, to state in narrative form that the period-end positions reported in the schedule of investments and the realized and unrealized gain or loss from derivatives appearing in the statement of operations are indicative of the volume of derivatives used during the period, to present ranges (minimum and maximum) of use during the year, or to present an average notional volume for the year.
- For disclosure of credit derivatives, the staff observed that in some instances it was difficult to identify whether a registrant had purchased or sold a particular position, with the only distinction apparent from inclusion of the additional disclosure of the current status of the payment or performance risk of the credit derivative required by FASB ASC 815-10-50-4K for written credit derivatives. The staff urged identification between purchased and written derivatives in a manner that is clear to less sophisticated readers. Similarly, when credit derivatives are sold, and the additional FASB ASC 815-10-50-4K disclosure requirement of risk of performance under the contract is expressed by presenting current credit spreads, an explanation should be provided of the relationship between the size of the credit spreads and the likelihood the fund will have to make payment to the counterparty under the derivative contract to enhance transparency.
- The staff observed that certain funds did not disclose the counterparties to OTC swaps and forwards in the financial statements. The disclosure of counterparties to OTC derivative contracts is, in the staff's view, a material component of the security description as required by Regulation S-X. However, counterparties to exchange-traded derivatives need not be disclosed as, typically, the exchange stands behind the performance obligation under the contract regardless of the executing counterparty.

Changes of Period-Ends; Fund Mergers

.77 Generally, Rule 30e-1 of the 1940 Act, "Reports to Stockholders of Management Companies," requires investment companies to transmit financial statements to shareholders at least semiannually, within 60 days after period-end. The staff has delegated authority to grant extensions to the transmission requirement if the fund can demonstrate "good cause." If an investment company changes its fiscal year-end or semiannual reporting period by one month, the staff may provide no-action relief to allow a 15-day delay in order to issue a single shareholder report containing financial statements with separate columns and separate schedules of investments for the most recent six-month or annual period along with the short one-month "stub" period. For example, if in April an investment company changes its fiscal year-end from July 31 to August 31, the registrant can request relief to issue a single report, containing financial statements for the 12 months ended July 31 and the one-month period ended August 31, within 75 days of July 31. Another example is when an investment company changes its fiscal year-end from January 31 to August 31, in lieu of providing an unaudited semiannual report to shareholders for the six-month period ended July 31, the registrant can request relief to issue a single audited report, containing financial statements for the seven-month period ended August 31, within 75 days of July 31. In both examples, all periods presented must be audited, transmitted to shareholders, and filed on Form N-CSR within 75 days of July 31. A form letter is available from the staff to request the no-action relief containing the applicable conditions; registrants anticipating a one-month change in fund reporting periods are encouraged to contact the staff to obtain the form letter.

.78 The reporting of pro forma financial information in Form N-14 filings for investment company mergers is governed by Article 11 of Regulation S-X. Rule 11-02(b)(1) of Regulation S-X permits a narrative description of the pro forma effects of the transaction in lieu of condensed pro forma financial statements when there are a limited number of pro forma adjustments and those adjustments are easily understood. Narrative descriptions should include significant elements of the transaction, including, but not limited to

1. A general description of the merger, including the identification of the investment company whose financial performance will be carried over to financial statements prepared in future periods;

   Note: For transactions structured as mergers of multiple registered management investment companies, disclosure of whether the mergers are contingent upon the target companies' shareholders approving the merger.

2. Disclosure of the cost of the merger to each of the participating registered management investment companies and rationale for cost allocation, whether or not the merger is consummated;

3. A general description of the tax consequences of the merger, including the capital loss carryforwards available to each investment company and whether those capital loss carryforwards are subject to expiration or limitation;

4. Disclosure of information related to portfolio realignment, if any, that will take place after consummation of the merger, including

   a. the reasons for portfolio realignment,

   b. the extent and cost of portfolio realignment,

   c. the percentage of the target company's portfolio that is expected to be sold as a result of portfolio realignment and an estimate of the related realized gains expected to result from such sales, and

   d. a statement that total merger costs do not reflect commissions that would be incurred during portfolio realignment;

5. Pro forma effects of the transaction (assuming all investment companies subject to merger had merged) on

   a. the significant accounting policies, including valuation policies,

   b. net assets,

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c. management fees and other expenses, and

d. any other significant adjustments resulting from the transaction; and

6. Reference to the audited financial statements of each investment company participating in the merger

Money Market Funds

.79 The staff has noted inconsistencies in the maturity dates of portfolio securities that are disclosed in money market funds' schedules of investments. The staff has taken the position that when disclosing maturity date required by Article 12-12 of Regulation S-X, at a minimum, money market funds should report the date when the fund is unconditionally permitted to demand repayment (the "demand date"). Reporting the demand date is consistent with the recently adopted weighted average life calculation under Rule 2a-7 of the 1940 Act. In addition to reporting the demand date, money market funds may also report the next interest rate reset date and the legal maturity date. Also, the staff believes this guidance to be appropriate for other types of fixed-income funds (for example, ultra-short bond funds).

.80 The staff has received inquiries from registrants who manage multiclass money market mutual funds. In certain instances, a fund may have realized a loss on a portfolio security which was appropriately allocated among the fund's classes on the realization date. Subsequently, one of the classes had a significant redemption that caused the net asset value per share of that individual class to deviate from a constant $1.00, even though it is immediately evident that the fund as a whole is not impaired (that is, the fund as a whole did not "break the buck"). The staff expressed a view that, in these instances, it is not inconsistent with Rule 18f-3 under the 1940 Act to reallocate the loss among classes based on the relative net assets attributable to each class at the current date as long as the following conditions are met: (i) All shareholders subscribe to and redeem from the money market fund at $1 per share; (ii) One class "breaks the buck" due to a large redemption which was processed at $1 per share but the fund's shadow priced *net asset value* (NAV) measured at the fund level does not "break the buck;" (iii) the fund's Board of Directors believes that retroactive reallocation is in the best interests of shareholders, is fair to shareholders, and approves the reallocation in accordance with Rule 18f-3; and (iv) the retroactive reallocation results in an annualized rate of return of each class that differs by class specific expenses.

.81 Finally, the staff reminded registrants that Item 74W of Form N-SAR requires registrants to report the NAV of money market funds based on a "mark-to-market" value (that is, the "shadow price") of the fund at the period-end date, not at the amortized cost value.

SEC Final Rule Developments

Custody of Funds or Securities of Clients by Investment Advisers

.82 In December 2009, the SEC adopted rules designed to substantially increase the protections for investor funds and securities of which an investment adviser registered with the SEC has custody. Depending on the investment adviser's custody arrangement, the rules would require the adviser to be subject to a surprise examination and, in certain cases, custody controls examination that were generally not required under the previous rules. The effective date of the amendment is March 12, 2010, subject to certain exceptions. Readers are encouraged to review the full text of Rule Release No. IA-2968 *Custody of Funds or Securities of Clients by Investment Advisers* and the related Interpretive Release No. IA-2969, *Commission Guidance Regarding Independent Public Accountant Engagements Performed Pursuant to Rule 206(4)-2 Under the Investment Advisers Act of 1940*. Additionally, both the SEC and the AICPA have released frequently asked questions about the custody rule which can be located at www.sec.gov/divisions/investment/custody_faq_030510.htm and www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/DownloadableDocuments/AICPA_IC_EP_FAQ_custody_rule_August_17.pdf, respectively.

.83 An examination of funds and securities must be conducted pursuant to paragraph (a)(4) of Rule 206(4)-2 under the Investment Advisers Act of 1940. This rule requires that all registered investment advisers (or an investment adviser required to register) who have custody of client funds or securities, as defined, have

an independent public accountant conduct an examination on a surprise basis once every calendar year. The rule defines *custody* to mean an investment adviser, or its related person, holding, directly or indirectly, client funds or securities, or having any authority to obtain possession of them. Custody includes:

- possession of client funds or securities (but not of checks drawn by clients and made payable to third parties) unless the investment adviser receives them inadvertently and returns them to the sender promptly but in any case within three business days of receiving them;
- any arrangement (including a general power of attorney) under which the investment adviser is authorized or permitted to withdraw client funds or securities maintained with a custodian upon the investment adviser's instruction to the custodian; and
- any capacity (such as general partner of a limited partnership, managing member of a limited liability company or a comparable position for another type of pooled investment vehicle, or trustee of a trust) that gives the investment adviser or their supervised person legal ownership of or access to client funds or securities.

.84 An adviser that has the authority to transfer a client's assets between the client's accounts maintained at one or more qualified custodians, if the client has authorized the investment adviser in writing to make such transfers and a copy of that client specific authorization is provided to the qualified custodian, is not deemed to have custody. An investment adviser is deemed to have custody if it has an identification number and password providing it with the ability to withdraw funds or securities or transfer them to an account not in the client's name at a qualified custodian. Additionally, *related person* is defined in the rule as any person, directly or indirectly, controlling or controlled by the investment adviser, and any person that is under common control with the investment adviser. Legal assistance may be required for determining whether an investment adviser is deemed to have custody.

.85 The independent public accountant must file a certificate on Form ADV-E with the SEC within 120 days of the time chosen by the independent public accountant, stating that it has examined the funds and securities and describing the nature and extent of the examination. Rule 206(4)-2(a)(4)(ii) under the Investment Advisers Act of 1940 states that the independent accountant, upon finding any material discrepancies during the course of the examination, should notify the SEC within one business day of the finding, by means of a facsimile transmission or electronic mail, followed by first-class mail, directed to the attention of the Director of the Office of Compliance Inspections and Examinations. This surprise examination and report follow the provisions of AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1). AT section 601 enables true direct reporting on the subject matter. The rule also requires that a qualified custodian maintain client funds and securities in a separate account for each client under that client's name or in accounts that contain only the clients' funds and securities, under the adviser's name as agent or trustee for the clients. Clients must be notified promptly in writing of the qualified custodian's name, address, and the manner in which the funds or securities are maintained, when an account is opened by an investment adviser on a client's behalf and following any changes to this information. The investment adviser must also have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement, at least quarterly, to each of the investment advisers' clients for which it maintains funds or securities. Rule 206(4)-2(b) lists the exceptions to these requirements for shares of mutual funds, certain privately offered securities, fee deductions, limited partnerships subject to annual audit, registered investment companies, and certain related persons.

.86 The surprise examination must commence on or before December 31, 2010, but does not need to be completed until 120 days after the time chosen by the accountant performing the surprise examination. If the investment adviser maintains client assets as qualified custodian (as discussed subsequently), the first surprise examination must commence no later than six months after obtaining the internal control report. For an adviser that became subject to the rule after the effective date, the surprise examination must commence within six months after it became subject to the rule.

.87 Advisers to pooled investment vehicles may be deemed to comply with the surprise examination requirements of the rule by obtaining an audit of the pool and delivering the audited financial statements to pool investors within 120 days of the pool's fiscal year-end; for funds of funds, the financial statements must

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be distributed within 180 days. The audit must be conducted by an accounting firm registered with, and subject to regular inspection by, the PCAOB. If the accountant was not currently subject to inspection by the PCAOB, the investment adviser will still qualify for the exemption if the accountant becomes subject to regular inspection by the PCAOB before the issuance of the audited financial statements for the pooled investment vehicle's 2010 fiscal year. Lastly, the advisers to pools complying with the rule by distributing audited financial statements to investors must obtain an audit upon liquidation of the pool when the liquidation occurs prior to the pool's fiscal year-end. If the pooled investment vehicle does not distribute audited financial statements to its investors, the adviser must obtain an annual surprise examination and must have a reasonable basis, after due inquiry, for believing that the qualified custodian sends an account statement of the pooled investment vehicle to its investors in order to comply with the custody rule. For a pool that is not relying on the audit provision to satisfy the custody rule, the rule requires privately offered securities held by the pool to be placed with a qualified custodian (as defined subsequently); it also requires that the accounting firm performing the surprise examination to verify these privately offered securities, along with other funds and securities.

.88 If the investment adviser, or its related person, maintains client funds or securities as a qualified custodian in connection with advisory services provided to clients, additional requirements exist in accordance with Rule 206(4)-2(a)(6). A *qualified custodian* is defined by the rule as (*a*) a *bank* as defined in Section 202(a)(2) of the Investment Advisers Act of 1940 or a *savings association* as defined in Section 3(b)(1) of the Federal Deposit Insurance Act that has deposits insured by the FDIC under the Federal Deposit Insurance Act; (*b*) a broker-dealer, registered under Section 15(b)(1) of the Securities Exchange Act of 1934, holding the client assets in customer accounts; (*c*) a futures commission merchant (FCM), registered under Section 4f(a) of the Commodity Exchange Act, holding the client assets in customer accounts but only with respect to clients' funds and security futures or other securities incidental to transactions in contracts for the purchase or sale of a commodity for future delivery and options thereon; and (*d*) a foreign financial institution that customarily holds financial assets for its customers, provided that the foreign financial institution keeps the advisory clients' assets in customer accounts segregated from its proprietary assets. Therefore, custody does not equate to serving as a qualified custodian under the rule.

.89 When the investment adviser, or its related person, maintains the client funds and securities as a qualified custodian in connection with advisory services provided to clients, the independent public accountant engaged to perform the surprise examination must be registered with, and subject to regular inspection by, the PCAOB.

.90 An investment adviser that is a qualified custodian must at least once each calendar year obtain or receive from its related person a written internal control report related to its or its affiliates' custodial services, including the safeguarding of funds and securities, that includes an opinion from an independent public accountant that is registered with, and subject to regular inspection by, the PCAOB. The compliance date for obtaining an internal control report is September 12, 2010. Advisers that are newly subject to Rule 206(4)-2(a)(6) must obtain the internal control report within six months of becoming subject to the requirement. Regardless of whether an adviser to a pooled investment vehicle obtains a surprise examination or satisfies that requirement by obtaining an audit and distributing the audited financial statements to pool investors within 120 days of the end of the pooled investment vehicle's fiscal year (or 180 days for funds of funds), if the pooled investment vehicle's assets are maintained with a qualified custodian that is either the adviser to the pool or a related person of the adviser, the adviser to the pool would have to obtain, or receive from the related person, an internal control report. This requirement could be satisfied with a type 2 service auditor's report under Statement on Auditing Standards (SAS) No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324), or an examination report on internal control over compliance conducted in accordance with AT section 601. As explained in question XIII.3 of the SEC's "Staff Responses to Questions About the Custody Rule," in addition to the two types of reports mentioned previously and Release IA-2969, all of which that satisfy the requirements for an internal control report, a report under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, vol. 1) would also be acceptable. As discussed in the "Service Organizations" section of this alert, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801) will replace the guidance previously found in SAS No. 70. Therefore, this type of report would also satisfy the internal

control requirement. This internal control report must include an opinion concerning whether controls have been placed in operation as of a specific date and are suitably designed and operating effectively to meet control objectives relating to custodial services, including the safeguarding of funds and securities held by either the investment adviser or its related person on behalf of the advisory clients during the year. The internal control report does not need to address the effectiveness of controls over custodial services prior to March 12, 2010 (the effective date of the amended rule), even if it results in a shortened examination period for the 2010 report. Further, a qualified custodian that obtained a custody-related SAS No. 70 report in 2009 is not expected to alter its reporting cycle in 2010.

.91 The accountant must also verify that the funds and securities are reconciled to a custodian other than the investment adviser or its related person (for example, the Depository Trust Corporation). The accountant's tests of the custodian's reconciliation should include either direct confirmation, on a test basis, with unaffiliated custodians or other procedures designed to verify that the data used in the reconciliations performed by the qualified custodian is obtained from unaffiliated custodians and is unaltered.

.92 An independent accountant's illustrative report on examinations of securities pursuant to Rule 206(4)-2 of the Investment Advisers Act of 1940 and management's assertion can be found in the 2010 edition of the Audit and Accounting Guide *Investment Companies* as well as on the Investment Companies Expert Panel page on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/Pages/InvestmentCompanies.aspx. An illustrative report, developed under AT section 101, of an independent registered public accounting firm on management's assertion regarding controls at a custodian pursuant to Rule 206(4)-2 and Release No. IA-2969 under the Investment Advisers Act of 1940 can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/InvestmentCompanies/DownloadableDocuments/Custody_report_September_1final.pdf. Lastly, the SEC staff has prepared *Custody of Funds or Securities of Clients by Investment Advisers: A Small Entity Compliance Guide*, which can be accessed at http://sec.gov/info/smallbus/secg/custody_rule-secg.htm.

Money Market Fund Reform

.93 In February 2010, the SEC issued Release No. IC-29132, *Money Market Fund Reform*, which is designed to make money market funds more resilient to certain short-term market risks and to provide greater protections for investors in a money market fund that is unable to maintain a stable NAV per share. These amendments were issued in response to the substantial losses incurred by money market funds during the economic crisis, including the first time a significant money market fund "broke the buck." As an immediate response, the U.S. Department of Treasury and the Federal Reserve intervened with the Temporary Guarantee Program for Money Market Funds and the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility, both of which have since expired. The amendments will tighten the risk-limiting conditions of Rule 2a-7 of the 1940 Act by, among other things,

- requiring money market funds to maintain a portion of their portfolios in instruments that can be readily converted to cash, reducing the maximum weighted average maturity of portfolio holdings, and improving the credit quality of portfolio securities
- requiring money market funds to maintain liquidity buffers that will help them withstand sudden demands for redemptions
- requiring money market funds to report their portfolio holdings monthly to the SEC
- requiring fund managers to stress test their portfolios against potential economic shocks such as sudden increases in interest rates, heavy redemptions, and potential defaults
- permitting a money market fund that has "broken the buck" (that is, repriced its securities below $1.00 per share), or is at imminent risk of breaking the buck, to suspend redemptions to allow for the orderly liquidation of fund assets

.94 The basic premise underlying money market funds' use of the amortized cost method of valuation is that the high-quality, short-term debt securities these funds typically hold until maturity will eventually return to their amortized cost value, regardless of any current disparity between the amortized cost value and

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market value, and, moreover, that they would not ordinarily be expected to fluctuate significantly in value. Money market funds are permitted to continue valuing their portfolio securities at amortized cost as long as the deviation between the portfolio's amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current market-based NAV per share of the fund. To reduce the likelihood of a material deviation, the rules' risk-limiting conditions are intended to limit the fund's exposure to certain risks, such as credit, and interest rate risks. The rule also contains certain procedural requirements overseen by the fund's board of directors. For example, the fund must periodically compare the amortized cost NAV of the fund's portfolio against the mark-to-market NAV of the portfolio (its so-called shadow price). If a difference of more than one half of 1 percent (or $0.005 per share) occurs, the board must consider promptly what action, if any, should be taken.

.95 Many of these amendments became effective May 5, 2010. Readers are encouraged to review the full release, including the complete discussion of compliance dates in Section III. The staff of the Division of Investment Management has prepared some responses to questions about money market fund reform, which can be accessed at www.sec.gov/divisions/investment/guidance/mmfreform-imqa.htm.

Proxy Disclosure Enhancements

.96 Release No. IC-29092, *Proxy Disclosure Enhancements*, was issued by the SEC in December 2009 to enhance information provided in connection with proxy and information statements, annual reports and registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933 as well as the 1940 Act. This rule became effective on February 28, 2010. Management investment companies registered under the 1940 Act will now be required to have expanded disclosure regarding director and nominee qualifications; past directorships held by directors and nominees; legal proceedings involving directors, nominees, and executive officers to funds; and new disclosure about leadership structure and the board's role in the oversight of risk. These new disclosure requirements are in response to investors' increased interest in corporate accountability and will better enable shareholders to evaluate the leadership of public entities.

.97 This rule amends Schedule 14A and Forms N-1A, N-2, and N-3 for funds. If an existing fund's fiscal year ends on or after December 20, 2009, any proxy statement must be in compliance with the new proxy disclosure requirements if filed on or after February 28, 2010. If an existing fund has multiple series, and the fiscal year of any series ends on or after December 20, 2009, any posteffective amendment to the fund's existing registration statement must comply with the form amendments if the amendment is filed on or after February 28, 2010, and the amendment is filed to make changes that affect a series with a fiscal year that ends on or after December 20, 2009. The SEC has created two documents, "FAQs About Proxy Disclosure Enhancements Transition for Registered Investment Companies" and "Proxy Disclosure Enhancements Transition," both of which can be accessed at the SEC's website, www.sec.gov.

Internet Availability of Proxy Materials

.98 In February 2010, Release No. IC-29131, *Amendments to Rules Requiring Internet Availability of Proxy Materials*, was released with the intent to clarify and provide additional flexibility regarding the format of the "Notice of Internet Availability of Proxy Materials" to better communicate with shareholders. Explanatory materials regarding the reasons for the use of the notice and access to proxy rules and the process of receiving and reviewing proxy materials and voting pursuant to the notice and access proxy rules will be included.

.99 In 2007, the SEC established procedures that promote the use of the Internet as a reliable and cost-efficient means of making proxy materials available to shareholders. Issuers and other soliciting persons have an option to either send a full set of proxy materials to all shareholders or send shareholders only the notice. Many issuers have chosen to use the notice-only option because of its substantial cost savings. However, statistics indicate lower shareholder response rates to proxy solicitations when the notice-only option is used. These amendments will provide additional flexibility to provide to shareholders a more effective explanation of the importance and effect of the notice and the reasons for its use, which should better facilitate use of the SEC's rules and improve investor understanding.

.100 Prior to these amendments, a registered investment company was permitted to accompany the notice with a prospectus or report to shareholders. Consistent with permitting mutual funds to use a summary prospectus to satisfy their delivery obligations, the rules have been revised to permit mutual funds to accompany the notice with a summary prospectus. These amendments became effective on March 29, 2010.

SEC Proposed Rule Developments

Distribution Fees and Confirmations

.101 The SEC's proposed rule Release No. IC-29367, *Mutual Fund Distribution Fees; Confirmations*, was issued during July 2010 and would replace Rule 12b-1 under the 1940 Act with Rule 12b-2. Historically, Rule 12b-1 has permitted registered open-end management investment companies to use fund assets to pay for the cost of promoting sales of fund shares. Funds would continue to be allowed to bear promotional costs within certain limits. The proposed framework would:

- continue to allow funds to give investors choices regarding how and when to pay for sales charges
- improve disclosure designed to enhance investor understanding of those charges
- limit the cumulative sales charges each investor pays (no matter how they are imposed)
- eliminate uncertainties associated with current requirements while providing a more appropriate role for fund directors

.102 The proposal also includes requirements for clearer disclosures about all sales charges in fund prospectuses, annual and semiannual reports to shareholders, and investor confirmation statements. Funds and their underwriters would have the option of offering classes of shares that could be sold by dealers with sales charges set at competitively established rates—rates that could better reflect the services offered by the particular intermediary and the value investors place on those services. For funds electing this option, the amendments would provide relief from restrictions currently in place that limit retail price competition for distribution services.

.103 In 2009, funds collected $9.5 billion in Rule 12b-1 fees. Currently, sales charge arrangements are disclosed in fund prospectuses and are governed by statutory provisions and rules adopted by the SEC and FINRA. Rule 12b-1 requires that, before using fund assets to pay for distribution expenses, a fund must adopt a written plan (a "Rule 12b-1 plan") describing all material aspects of the proposed financing of distribution, which must contain provisions similar to several of those the 1940 Act requires for advisory contracts between the fund and its investment adviser. The Rule 12b-1 plan must be approved initially by the fund's board of directors as a whole and then separately by the "independent" directors. The rule does not restrict the amounts of the fees that may be approved under the plan; however, rules adopted by FINRA effectively set the maximum Rule 12b-1 fees by prohibiting broker-dealers from selling funds that pay more than 25 basis points per year of fund assets as "service fees" and more than 75 basis points per year of fund assets as asset-based sales charges. The rule requires directors (including a majority of the independent directors) to conclude, in exercising their reasonable business judgment and in light of their fiduciary duties, that a reasonable likelihood exists that the plan will benefit both the fund and its shareholders.

.104 Many of the assumptions used in the adoption of Rule 12b-1 appear to no longer reflect current marketplace realities, including the role that these fees play in the distribution of fund shares and the tasks that directors should be required to undertake in considering whether to approve Rule 12b-1 fees. Further, many investors are unsure of the role and importance of Rule 12b-1 fees. This led to the rescission of Rule 12b-1 in its entirety, as proposed by this rule (as opposed to amending it).

.105 The new approach outlined in proposed Rule 12b-2, differentiates between the two constituent parts of existing Rule 12b-1 fees (asset-based sales charges and service fees). Funds would be able to use a limited amount of fund assets to pay for any distribution related expenses, but the maximum amount would be tied to the service fee limit imposed by the FINRA sales charge rule (currently 25 basis points per year). By amending Rule 6c-10, funds would also be permitted to deduct from fund assets amounts in excess of the

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marketing and service fee. This would be called an "ongoing sales charge," and these charges would be treated as another form of sales load.

.106 Limits on asset-based sales charges would also be imposed by referencing the front-end load imposed by the fund or, if none, by referencing the aggregate sales load cap imposed under the FINRA sales charge rules for funds with an asset-based sales charge and service fee (currently 6.25 percent). These limits would be based on the cumulative amounts of sales charges that an investor pays in any form (front-end, deferred, or asset-based). A fund that imposes an ongoing sales charge must automatically convert fund shares to a class of shares without an ongoing sales charge no later than when the investor has paid cumulative charges that approximate the amount the investor otherwise would have paid through a traditional front-end load (or, if none, the 6.25 percent cap). The new rule would shift the focus of the limits from how much fund underwriters may collect in asset-based sales charges (a fund-level cap) to how much individual shareholders will pay either directly or indirectly (a shareholder account-level cap).

.107 Another amendment to Rule 6c-10 would permit an alternative, elective distribution model. In this new model, intermediaries of a fund could impose charges for sales of the fund's shares at negotiated rates, much like they charge commissions on sales of ETFs and other equity securities. The proposed rule would permit fund intermediaries to charge sales loads other than those established by the fund underwriter and disclosed in the fund prospectus.

.108 Under the proposal, funds would be required to comply with the amendments for all shares issued after the compliance date of the new rules. However, a five-year grandfathering period would exist after the compliance date for share classes issued prior to the compliance date and would deduct fees pursuant to the existing Rule 12b-1, after which those shares would be required to be converted or exchanged into a class that does not deduct an ongoing sales charge. The full text of the proposed rule can be accessed at the SEC's website, www.sec.gov. Comments on these amendments are due by November 5, 2010.

Target Date Retirement Fund Names and Marketing

.109 The SEC issued a rule proposal in June 2010 to help clarify the meaning of a date in a target date fund's name, enhance the information provided to investors in these funds as they invest for retirement, and reduce the potential for investors to be confused or misled regarding these and other investment companies. Concerns about target date retirement funds were brought about from market losses incurred during the recent financial crisis and the increasing significance of target date funds in 401(k) plans. Specific concerns have also been raised regarding the naming of these funds and their marketing.

.110 The rule amendments would:

- require a target date retirement fund that includes the target date in its name to disclose the fund's asset allocation at the target date immediately adjacent to the first use of the fund's name in marketing materials
- require marketing materials for target date retirement funds to include a table, chart, or graph depicting the fund's asset allocation over time, together with a statement that would highlight the fund's final asset allocation
- require a statement in marketing materials to the effect that a target date retirement fund should not be selected based solely on age or retirement date and is not a guaranteed investment; additionally, the stated asset allocations may be subject to change
- provide additional guidance regarding statements in marketing materials for target date retirement funds and other investment companies that could be misleading

.111 Comments on this proposal were due in August 2010. To further explain target date funds, the SEC also issued an Investor Bulletin jointly with the Department of Labor. Both documents can be accessed at the SEC's website, www.sec.gov.

CFTC Developments

Commodities

.112 Global futures and options contract volume increased comparing the first six months of 2010 to the same period in 2009. In the first six months of 2010, volume on U.S. futures exchanges was 3.6 billion contracts, a 16 percent increase from the same period in 2009. Volume traded on foreign exchanges amounted to 7.6 billion contracts in the first six months of 2010. Trading volume in interest rate and equity products continued to account for more than half of worldwide trading volume.

.113 The total amounts required under CFTC regulations to be held in segregated or secured accounts on behalf of FCM customers decreased by $8 billion from approximately $175 billion as of June 30, 2009, to approximately $167 billion as of June 30, 2010.

Off-Exchange Retail Foreign Currency Transactions

.114 The CFTC issued final regulations concerning off-exchange retail foreign currency transactions effective October 18, 2010. The rules implement provisions of the Dodd-Frank Act and the Food, Conservation, and Energy Act of 2008, which, together, provide the CFTC with broad authority to register and regulate entities wishing to serve as counterparties to, or to intermediate, retail foreign exchange (forex) transactions.

.115 The final forex rules put in place requirements for, among other things, registration, disclosure, recordkeeping, financial reporting, minimum capital, and other business conduct and operational standards. Specifically, the regulations require:

- counterparties offering retail foreign currency contracts as either FCMs or retail foreign exchange dealers (RFEDs), a new category of registrant, to be registered.
- persons who solicit orders, exercise discretionary trading authority, or operate pools with respect to retail forex also will be required to register, either as introducing brokers, commodity trading advisers, commodity pool operators (as appropriate), or as associated persons of such entities to be registered.
- "otherwise regulated" entities, such as U.S. financial institutions and SEC-registered brokers or dealers, remain able to serve as counterparties in such transactions under the oversight of their primary regulators.
- FCMs and RFEDs to maintain net capital of $20 million, plus 5 percent of the amount, if any, by which liabilities to retail forex customers exceed $10 million.
- leverage in retail forex customer accounts will be subject to a security deposit requirement to be set by the NFA within limits provided by the CFTC.
- all retail forex counterparties and intermediaries will be required to distribute forex-specific risk disclosure statements to customers and comply with comprehensive recordkeeping and reporting requirements.

.116 The final rule may be found in the Federal Register at www.federalregister.gov/articles/2010/09/10/2010-21729/regulation-of-offexchange-retail-foreign-exchange-transactions-and-intermediaries#p-3.

Minimum Adjusted Net Capital Requirements of FCMs and Introducing Brokers

.117 Effective as of March 31, 2010, the CFTC revised financial requirements for FCMs and introducing brokers (IBs). The revised requirements affect FCM financial requirements by

- increasing the minimum dollar capital requirement to $1,000,000;
- increasing the risk-based capital requirement for noncustomer accounts from 4 percent to 8 percent of the total risk margin requirement for positions carried in noncustomer accounts; and

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- including cleared OTC derivative positions in an FCM's risk-based capital calculation for customer and noncustomer accounts.

.118 The CFTC also revised the financial requirements for IBs by increasing the net capital requirement from $30,000 to $45,000. The CFTC's increase to the IB minimum capital requirement brings it to the same level currently required under NFA Financial Requirements Section 5, "Introducing Broker Financial Requirements." The final rule may be found at www.cftc.gov/LawRegulation/FederalRegister/FinalRules/e9-31058.html.

Exemption From Certain CFTC Regulations

.119 In May 2010, the CFTC published an informational and guidance document regarding the application procedure pursuant to CFTC Regulation 30.10, which generally provides that persons located and doing business outside the United States and who are subject to a comparable regulatory framework in the country in which they are located may qualify for an exemption from the application of certain CFTC regulations, including relief from registration as an FCM. For more information, please refer to the Foreign Markets, Products, & Intermediaries subheading under the "International" tab of www.cftc.gov (or directly at www.cftc.gov/International/ForeignMarketsandProducts/index.htm). Appendix A to Part 30 of the CFTC's Regulations generally outlines the procedure for a foreign regulator or self-regulatory organization seeking to obtain relief on behalf of a foreign broker subject to its oversight. As the operating division responsible for evaluating applications pursuant to Regulation 30.10, the Division of Clearing and Intermediary Oversight (DCIO) prepared and published a more detailed description of the information set forth in appendix A. In particular, the guidance is intended to streamline the application process by informing prospective Regulation 30.10 applicants of the information generally requested by DCIO when evaluating applications for Regulation 30.10 relief.

Commodity Pool Operator Reporting

.120 The CFTC amended its regulations governing the periodic account statements that commodity pool operators (CPOs) are required to provide to commodity pool participants and, effective for 2009, the annual financial reports that CPOs are required to provide to commodity pool participants and file with the NFA. The amendments became effective December 9, 2009, and changes that affect annual reporting requirements were applicable to commodity pool annual reports for fiscal years ending December 31, 2009, and later. The amendments

- specify detailed information that must be included in the periodic account statements and annual reports for certain commodity pools with more than one series or class of ownership interest;
- clarify that the periodic account statements must disclose either the NAV per outstanding participation unit in the pool, or the total value of a participant's interest or share in the pool;
- extend the time period for filing and distributing annual reports of commodity pools that invest in other funds;
- codify existing CFTC staff interpretations regarding the proper accounting treatment and financial statement presentation of certain income and expense items in the periodic account statements and annual reports;
- streamline the final reporting requirements for pools ceasing operation;
- establish conditions for use of International Financial Reporting Standards (IFRS) in lieu of U.S. generally accepted accounting principles (GAAP) and a notice procedure for CPOs to claim such relief; and
- clarify and update several other requirements for periodic and annual reports prepared and distributed by CPOs.

CFTC Annual "Dear CPO" Letter

.121 On January 21, 2010, CFTC staff issued its annual letter to CPOs outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The CFTC anticipates issuing a similar letter in January 2011. The letter emphasizes the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff also suggests that CPOs share the letter with their independent auditors. Major concerns addressed in the letter include the following:

- Filing procedures and due dates of commodity pool financial filings
- Master-feeder and fund of funds
- Requests for limited relief from U.S. GAAP compliance for certain offshore commodity pools
- CPOs claiming exemption under Regulation 4.13
- Reports of liquidating pools
- Reports of series funds structured with a limitation on liability among the different series
- Accounting developments
    - FASB ASC
    - Disclosures about derivative instruments
    - AICPA Commodities Audit Practice Aid
    - AICPA Audit Risk Alerts
    - FASB ASC 820
    - AICPA Practice Aid *Alternative Investments—Audit Considerations*
    - AICPA Technical Guidance, specifically Technical Questions and Answers (TIS) section 6910.23, "Accounting Treatment of Offering Costs Incurred by Investment Partnerships" (AICPA, *Technical Practice Aids*)

.122 The clearing and intermediary oversight division has issued similar letters in prior years, which are available at the CFTC's website. Prior letters from 1998 forward are available at the CFTC's website at www.cftc.gov/IndustryOversight/Intermediaries/CPOs/guidancecporeports.html. Those letters should be consulted with respect to commodity pool annual financial statements and reporting. Readers are encouraged to view the full text of this letter at www.cftc.gov/ucm/groups/public/@iointermediaries/documents/file/cpoannualguidanceletter2009.pdf and to monitor the CFTC website for the most recent guidance.

.123 Auditors may also consider additional CFTC guidance related to auditing regulatory supplementary schedules, maintaining minimum financial requirements and notification requirements, segregation of customer funds in multiple currencies, and forex transactions. Readers may refer to the CFTC website for additional details.

National Futures Association

Commodity Pools

.124 NFA adopted compliance rules applicable to CPOs as follows:

- Rule 2-45, "Prohibition of Loans by Commodity Pools to CPOs and Related Entities," prohibits a CPO from permitting a commodity pool to use any means to make a direct or indirect loan or advance of pool assets to the CPO or any other affiliated person or entity.
- Rule 2-46, "CPO Quarterly Reporting Requirements," effective for the quarter ended March 31, 2010, requires each CPO member to file certain information on a quarterly basis to NFA, using NFA's

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EasyFile System, for each pool it operates that has a reporting requirement under CFTC Regulation 4.22 (which includes exempt pools under CFTC Regulation 4.7). Within 45 days after the end of each quarterly reporting period, CPOs must report:

- the identity of the pool's administrator, carry broker(s), trading manager(s) and custodian(s);
- a statement of changes in NAV for the quarterly reporting period;
- the monthly performance for the three months comprising the quarterly reporting period; and
- a schedule of investments identifying any investment that exceeds 10 percent of the pool's NAV at the end of the quarterly reporting period.

Foreign Currency Exchange Transactions

.125 Effective October 1, 2010, the NFA amended its Financial Requirements Section 11(b) and (c) and its related Interpretive Notice 9053, *Forex Transactions* (www.nfa.futures.org/nfamanual/NFAManual.aspx?RuleID=9053&Section=9), to remove regulated foreign equivalents from kinds of entities considered suitable locations for assets to be considered current for purposes of determining a forex dealer member's (FDM's) adjusted net capital or to cover its currency positions. Therefore, FDMs will no longer be able to treat assets held at regulated foreign equivalents of such exempt entities as current.

.126 Notwithstanding this, the amendments will continue to permit NFA to approve the use of certain foreign equivalent entities that are appropriately regulated and capitalized. Section (C)(3) of Interpretive Notice 9053 lists the factors NFA considers when determining whether to approve an otherwise unregulated entity for purposes of Financial Requirements Section 11(b) and (c).

Global Investment Performance Standards

.127 Although compliance with the Global Investment Performance (GIPS) standards is voluntary, an investment management firm's claim of compliance with the performance standards is widely regarded as providing a competitive advantage. The performance standards include both required and recommended guidelines for calculating and reporting performance. The performance standards recommend that firms obtain independent third-party verification of a firm's claim of compliance with the performance standards. Statement of Position 06-1, *Reporting Pursuant to the Global Investment Performance Standards* (AICPA, *Technical Practice Aids*, AUD sec. 14,420) provides guidance to practitioners for engagements to examine and report on aspects of a firm's compliance with the GIPS standards (a verification engagement) and for engagements to examine and report on the performance presentation of specific composites (a performance examination). Such examination engagements should be performed pursuant to AT section 101.

.128 In January 2010, the CFA Institute released revised GIPS standards. The significant changes to the GIPS standards include the requirement of assets to be valued using a fair value methodology when no market value is available, the requirement to present the standard deviation (widely accepted as a common measure of portfolio risk) of the monthly returns of both the composite and the benchmark, the requirement for the firms to disclose their verification status (that is, whether they have been verified), and required prescribed language describing what is and is not covered by verification. The effective date for the 2010 edition of the GIPS standards is January 1, 2011. Compliant presentations that include performance for periods that begin on or after that date must be prepared in accordance with the 2010 edition of the GIPS standards. Early adoption is recommended. See www.gipsstandards.org/ for more information.

PCAOB Constitutionality

.129 On June 28, 2010, the Supreme Court ruled in a lawsuit challenging the constitutionality of the PCAOB. When the PCAOB was set up under SOX, its board members were appointed by the SEC and could be removed only for cause. The Supreme Court ruled, in a 5-4 vote, that although the manner in which the

PCAOB was constituted was constitutionally invalid, SOX itself was not invalidated. Rather, the Supreme Court severed from the rest of SOX the provisions relating to the removal of PCAOB board members. The consequence of the Supreme Court's decision is that PCAOB board members will now be removable by the SEC at will, instead of only for good cause. Essentially, this decision has no material impact on the workings of the PCAOB, and all PCAOB programs will continue to operate as usual, including registration, enforcement, and standard-setting activities.

Audit and Attestation Issues and Developments

Audit Risks Arising From Current Economic Conditions

.130 The recent economic conditions and regulatory actions described in this alert may cause additional risk factors that had not previously existed or did not have a material effect on audit clients. Some risks that may affect an entity in the current economic environment are as follows:

- Marginally achieving explicitly stated strategic objectives
- Volatile real estate and business markets
- Significant measurement uncertainty, including accounting estimates and fair value measurements
- Potentially erroneous or fraudulent activity due to decreased staffing and resurgence of business activity
- The continuing evolution of the postrecessionary marketplace

.131 Although many of these risks are not new to businesses, consideration of the ways a client is affected by external forces is part of obtaining an understanding of the entity and its environment and will allow the auditor to plan and perform the audit to address those risks. As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or increasing audit procedures to obtain more persuasive evidence. Additionally, given the constantly changing status of economic conditions that could affect your client, auditors should consider modifying audit procedures to ensure that risks are still adequately addressed.

.132 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues as you perform your engagements.

PCAOB Observations Related to Audit Risk Areas Affected by the Economic Crisis

.133 In September 2010, the PCAOB released *Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis*. This report was issued to discuss the audit risks and challenges that resulted from the economic crisis that the PCAOB identified through its inspection program. This report covers inspections from the 2007, 2008, and 2009 inspection cycles, which generally involved reviews of audits of issuers' fiscal years ending from 2006–2008. One of the heightened risk factors identified by the PCAOB that is of particular importance to investment companies is in the audit area of fair value measurements. The economic crisis increased uncertainty around fair value measurements, which significantly increased audit risk. Failing to properly test issuers' fair value measurements and disclosures may lead to the auditor not detecting a material misstatement in issuers' financial statements, which may cause investors to be misled.

.134 The following is a summary of the PCAOB observations that investment companies may find pertinent. Firms sometimes planned to test issuers' estimates of fair value of financial instruments by performing procedures that included evaluating the reasonableness of the issuer's significant assumptions

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and testing the valuation model and the underlying data. Deficiencies observed by inspectors included firms' failures to

- evaluate, or evaluate sufficiently, whether fair value measurements were determined using appropriate valuation methods. In some cases when the issuer used an external valuation, the firms failed to obtain a sufficient understanding of the valuation methods used by these third parties.
- test, or adequately test, controls over issuers' valuation processes. In some cases, by failing to test, or test sufficiently, the operating effectiveness of internal controls over various aspects of issuers' valuation processes, the firms did not have adequate support for the degree of reliance placed on these controls.
- evaluate or evaluate sufficiently, the reasonableness of management's significant assumptions. Examples of this include not performing tests beyond inquiries of management; not appropriately evaluating the reasonableness of assumptions such as discount rates, credit loss expectations, and prepayment assumptions; and not involving a valuation specialist when appropriate.
- evaluate available evidence that was inconsistent with issuers' fair value estimates.

.135 Alternatively, some firms evaluated issuers' estimates of fair value of financial instruments by developing an independent expectation of fair value. Firms often used external pricing services or external valuation specialists to make this evaluation. Deficiencies of the firms observed in this situation included failing to understand the methods or assumptions used by these external parties and failing to evaluate significant differences between the independent estimates used or developed by firms and the fair values recorded by issuers.

.136 Further, firms sometimes failed to test, or test sufficiently, significant, difficult-to-value securities (for example, limiting their testing to inquiries of issuer personnel). Firms also failed to perform sufficient procedures in light of the volatile market conditions, to provide a reasonable basis for extending to year end the conclusions regarding the valuation of investment securities that were reached at an interim date. There were also instances in which firms failed to perform sufficient tests to determine whether issuers' fair value disclosures were in conformity with the requirements of FASB ASC 820.

.137 The report also discusses deficiencies observed in other audit areas affected by the economic crisis. The observations from this report will serve to inform future PCAOB actions in connection with certain inspection, enforcement, and standard-setting activities, and consideration will be given regarding whether additional guidance is needed relating to existing standards. The report can be accessed at http://pcaobus.org/Inspections/Documents/4010_Report_Economic_Crisis.pdf.

PCAOB Auditing Standards on Risk Assessment

.138 In August 2010, the PCAOB adopted a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit. These standards were initially proposed in late 2008 and reproposed in late 2009. These risk assessment standards will benefit investors by setting forth requirements that enhance the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. They apply to audit procedures spanning from the initial planning stages of the audit to the evaluation of the audit results. Improvements in the risk assessment standards should enhance integration of the audit of financial statements with the audit of internal control over financial reporting by articulating a process for identifying and assessing risks of material misstatements that apply to both portions of the integrated audit.

.139 The new auditing standards, with a brief description of each, are as follows:

- Auditing Standard No. 8, *Audit Risk*, discusses the auditor's consideration of audit risk in both an integrated audit and an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing it to an appropriately low level.
- Auditing Standard No. 9, *Audit Planning*, establishes requirements for planning an audit, such as assessing important matters and establishing an appropriate audit strategy.

- Auditing Standard No. 10, *Supervision of the Audit Engagement*, applies to the engagement partner and other team members who supervise during the audit. It sets forth requirements for supervision of the audit engagement and the work of other engagement members. Related to this topic, the PCAOB also recently issued a release discussing the SOX provision that authorizes the PCAOB to impose sanctions on registered public accounting firms and their supervisory personnel for failing to reasonably supervise associated persons.
- Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit*, describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
- Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, establishes requirements for auditors in identifying and assessing risks of material misstatement, including information-gathering procedures.
- Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*, establishes requirements for responding to those identified risks of material misstatement through general audit procedures. It also includes audit procedures related to significant accounts and disclosures.
- Auditing Standard No. 14, *Evaluating Audit Results*, establishes requirements for evaluating audit results and the sufficiency of appropriate audit evidence.
- Auditing Standard No. 15, *Audit Evidence*, discusses what constitutes audit evidence and how to design and perform audit procedures to support the opinion expressed in the auditor's report.

.140 These risk assessment standards will supersede the following six PCAOB interim standards and related amendments: AU section 311, *Planning and Supervision*; AU section 312, *Audit Risk and Materiality in Conducting an Audit*; AU section 313, *Substantive Tests Prior to the Balance Sheet Date*; AU section 319, *Consideration of Internal Control in a Financial Statement Audit*; AU section 326, *Evidential Matter*; and AU section 431, *Adequacy of Disclosure in Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards). The standards, if approved by the SEC, will be effective for audits of fiscal periods beginning on or after December 15, 2010.

.141 In September 2010, the SEC published *Notice of Filing of Proposed Rules on Auditing Standards Related to the Auditor's Assessment of and Response to Risk and Related Amendments to PCAOB Standards* to solicit comments on the proposed rules. This notice was posted in the *Federal Register* on September 27, 2010. Comments were due 21 days from the publication of the notice in the *Federal Register*, and the SEC will take action on the proposed rules 90 days from the publication of the notice in the *Federal Register*.

PCAOB Auditing Standard No. 7

.142 In January 2010, the PCAOB announced that the SEC had approved Auditing Standard No. 7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), which was adopted by the PCAOB in July 2009. Auditing Standard No. 7 provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. Auditing Standard No. 7 is expected to increase the likelihood that a registered public accounting firm will catch any significant deficiencies before it issues its audit report. As a result, more work may be necessary under this standard than performed under the existing requirements for concurring partners. However, Auditing Standard No. 7 explains that the procedures required by the engagement quality reviewer are different in nature than those required to be performed by the engagement team. Further, if the engagement quality reviewer deems more work is required before giving approval of issuance, the engagement team is responsible for completing that work.

.143 This standard applies to all audit engagements, and engagements to review interim financial information, conducted pursuant to the standards of the PCAOB, and it supersedes the PCAOB's interim concurring partner review requirement. Auditing Standard No. 7 is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009. For a public, calendar-year company, this standard is applicable for the quarter ended March 31, 2010. Subsequent to the

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issuance of Auditing Standard No. 7, the PCAOB issued Staff Question and Answer *Auditing Standard No. 7*, Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10), to provide further implementation guidance on the documentation requirements of the standard. For the full text of the standard and the question and answer, readers are encouraged to visit the PCAOB's website at www.pcaob.org.

PCAOB Practice Alert on Using the Work of Others

.144 In July 2010, the PCAOB issued Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants From Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06), because it observed that a number of registered public accounting firms located in the United States have been issuing audit reports on financial statements filed by issuers that have substantially all of their operations outside of the United States. This practice alert contains reminders for registered firms of their obligations when using the work of other firms or using assistants engaged from outside the firm, such as in the aforementioned situation. It also describes the circumstances under which the firm issuing the audit report may use the work and reports of another auditor.

.145 Auditors who engage assistants from outside their firm are governed by the same standards regarding planning the audit and supervising assistants when audit work is performed by assistants employed by the auditor's firm. Observations from the PCAOB's inspection process suggest that some firms may be issuing audit reports based on the work of another firm, or using the work of assistants engaged from outside the firm, without complying with the relevant PCAOB standards. The practice alert is broken down into two sections:

- Using the work of other auditors. This discussion is based upon AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards).
- Engaging assistants from outside the firm. This discussion is based upon numerous sections of auditing guidance.

.146 The full text of this practice alert can be found at http://pcaobus.org/Standards/QandA/2010-07-12_APA_6.pdf.

PCAOB Practice Alert on Significant Unusual Transactions

.147 In April 2010, the PCAOB issued Staff Audit Practice Alert No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05), which is intended to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions. Staff Audit Practice Alert No. 5 compiles existing requirements from PCAOB standards and groups them into the following categories: identifying and assessing risks of material misstatement, responding to risks of material misstatement, consulting others, evaluating financial statement presentation and disclosure, communicating with audit committees, and reviewing interim financial information. Staff Audit Practice Alert No. 5 can be accessed at http://pcaobus.org/Standards/QandA/04-07-2010_APA_5.pdf.

Supplementary and Other Information Related to Financial Statements

.148 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.149 SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information. *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

Supplementary Information in Relation to the Financial Statements as a Whole

.150 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of GAAS, *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

.151 The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. This SAS also may be applied, with the report wording adapted as necessary, when an auditor has been engaged to report on whether required supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole.

Required Supplementary Information

.152 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558), addresses the auditor's responsibility with respect to *required supplementary information*. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. In addition, authoritative guidelines for the methods of measurement and presentation of the information have been established. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. SAS No. 120 explains that the objectives of the auditor, when a designated accounting standard setter requires information to accompany an entity's basic financial statements, are to perform specified procedures in order to

- describe, in the auditor's report, whether required supplementary information is presented and
- communicate therein when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter or

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when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter.

Auditing Fair Value Measurements

.153 In addition to understanding the looming questions relative to fair value accounting, auditors should be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of equity are measured or disclosed at fair value in the financial statements, and it is management's responsibility to make the fair value measurements and disclosures. When auditing these fair values to ensure they are in conformity with U.S. GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*, vol. 1), which establishes standards and provides guidance for auditors. Specific types of fair value measurements are not covered by AU section 328. For example, when auditing the fair value of derivatives and securities, refer to AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1).

.154 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable price in an active market. If that is not available, a valuation method should incorporate common market assumptions. If common market assumptions are not available or require significant adjustments, the entity may use its own assumptions. The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. During this testing, the auditor also may identify any possible indicators of impairment. According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB ASC 820 under U.S. GAAP this may include evaluating the following:

- Whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.
- Whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- The reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)

.155 It is also important for the auditor to evaluate the reasonableness of the determination within the fair value hierarchy of inputs. FASB ASC 820 defines *level 1 inputs* as quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date; *level 2 inputs* are defined as inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly; and *level 3 inputs* are defined as unobservable inputs for the asset or liability. Further, in some cases the inputs used to measure fair value might fall in different levels of the fair value hierarchy. The level in the hierarchy within which the fair value measurement in its entirety falls should be determined based on the lowest level input that is significant to the fair value measurement in its entirety.

This classification by management has long-reaching effects in the financial statements through the various classification-based required disclosures. Auditors should be alert for circumstances in which the company may have an incentive to inappropriately classify fair value measurements within the hierarchy. As stated in paragraph .07 of AU section 312, misstatements can result from error or fraud and may consist of a financial statement disclosure that is not presented in conformity with GAAP.

Fair Values of Securities

.156 The guidance in AU section 332 relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support a fair value; however, when they are unavailable and the valuations of securities are obtained from a broker or dealer or another pricing service based on valuation models, the auditor should understand the underlying valuation method used (such as a cash flow projection). These prices also may be based on quoted prices from an active market or other observable inputs that will be a consideration on the auditor's procedures. The process used by the pricing service in measuring fair value should be evaluated to determine the consistency with the specified valuation method (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the valuing entity, which could inhibit objective pricing or underlying valuation assumptions that are highly subjective.

.157 When an entity performs its own valuation, procedures to test fair value include the following:

- Assessing the reasonableness of key factors and assumptions
- Comparing the assumptions to industry reports or benchmarks
- Assessing the appropriateness of the model
- Calculating the value using his or her own model
- Comparing the fair value with subsequent or recent transactions

.158 When extensive judgment is needed, consider using a specialist or refer to AU section 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.159 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles.

Auditing Accounting Estimates

.160 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in client financial statements. Some examples include the allowance for uncollectible accounts receivable, the impairment analysis, and the estimated useful lives of long lived assets.

.161 Given the current economic climate, additional skepticism should be exercised when considering management's underlying assumptions used in accounting estimates. When evaluating accounting estimates, the auditor should consider both the subjective and objective factors with professional skepticism. As discussed in paragraph .09 of AU section 342, key factors and assumptions that the auditor normally concentrates on include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

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.162 For example, in the current market, new patterns may emerge. In this economic climate, with possible increasing pressure on management to meet earnings, the determination of the reasonableness of management's accounting estimates would be made with an extra degree of professional skepticism. As noted by AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), when assessing audit differences between client estimates and audit estimates, even if they are individually reasonable, an auditor should consider whether these differences are indicative of possible bias by management. If so, the auditor should reconsider the estimates as a whole.

.163 The auditor should obtain an understanding of how management develops estimates and should employ one of the approaches outlined in paragraph .10 of AU section 342 in testing that process. In reviewing and testing management's process, the auditor may consider identifying controls around this process and determining if the underlying data used for the estimate are reliable and used appropriately. An auditor also may develop an estimate and compare it to management's estimate. Lastly, the auditor may review subsequent events or transactions occurring prior to the date of the auditor's report. Further, as noted in AU section 316, hindsight may provide the auditor additional insight into the existence of management bias. For further details on auditing estimates, see AU section 342. The AICPA has released a proposed redrafted SAS, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* (Redrafted), on auditing accounting estimates, including fair value. Readers are encouraged to remain alert for developments on this topic.

Using the Work of a Specialist

.164 It may be necessary to use a specialist (such as a securities valuation expert) to assist in auditing complex or subjective matters. Examples of matters in which an auditor may engage a specialist are valuation issues; reasonableness of determination of amounts derived from specialized techniques or models; or implementation of technical requirements, regulations, or legal documents. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*, vol. 1), provides guidance to auditors in using specialists. The guidance in AU section 336 is applicable when the specialist is hired by management or if the auditor engages the specialist. However, if a specialist employed by the auditor's firm participates in the audit, AU section 311, *Planning and Supervision* (AICPA, *Professional Standards*, vol. 1), is applicable rather than AU section 336.

.165 When using the work of a specialist, the auditor should evaluate the specialist's professional qualifications, obtain an understanding of the nature of the work performed or to be performed, and evaluate the relationship of the specialist to the client in terms of objectivity. Although the appropriateness and reasonableness of the methods and assumptions employed by the specialist are his or her responsibility, the auditor should obtain an understanding of these qualities, test the underlying data provided to the specialist, and evaluate the specialist's findings in the context of the audit and related assertions in the financial statements.

Auditor Responsibilities for Subsequent Events

.166 In September 2009, the AICPA issued TIS section 8700.02, "Auditor Responsibilities for Subsequent Events" (AICPA, *Technical Practice Aids*), which discusses the effects of the entity's responsibility to disclose the date through which the subsequent events have been evaluated on the auditor's responsibilities for subsequent events. This question and answer document was issued in response to FASB's issuance of FASB Statement No. 165, *Subsequent Events* (codified in FASB ASC 855, *Subsequent Events*). Because the auditor is concerned with events occurring through the date of his or her report that may require adjustment to, or disclosure in, the financial statements, the specific management representations relating to information concerning subsequent events should be made as of the date of the auditor's report. This typically will result in the same date being used for both the auditor's report and the date disclosed by management through which they have evaluated subsequent events. The auditor may consider discussing these dating requirements with management in advance of beginning the audit and including any agreed upon understanding in the engagement letter. In accordance with AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1), the auditor has no obligation to make any further or continuing inquiry or perform any other auditing procedures, with respect to the audited financial statements, after the date of the auditor's report, unless new information that may affect the report comes to

his or her attention. Recently issued technical questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx. See the "Subsequent Events" section of this alert for discussion of FASB ASC 855.

Communicating Internal Control Related Matters Identified in an Audit

.167 SAS No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), supersedes SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit*, and further clarifies standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 115 is effective for audits of financial statements for periods ending on or after December 15, 2009, with early implementation permitted.

.168 The SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion), except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1). In general, SAS No. 115 retains many of the provisions of SAS No. 112. The key differences between the two standards lie in the definitions of *significant deficiency* and *material weakness*.

Definitions of Significant Deficiency and Material Weakness

.169 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that a reasonable possibility exists that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable*, as those terms are defined in the FASB ASC glossary. The FASB ASC glossary defines *reasonably possible* as when the chance of the future event or events occurring is more than remote but less than likely; *probable* is defined as when the future event or events are likely to occur. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness yet important enough to merit attention by those charged with governance.

The Evaluation Process

.170 Although the auditor is not required to perform procedures specifically to identify deficiencies in internal control, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. Further, the severity of a deficiency does not depend on whether a misstatement actually occurred.

.171 The AICPA published the Audit Risk Alert *Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115* (product no. 022539) to assist in understanding the requirements of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Service Organizations

.172 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, vol. 1, AU sec. 324) has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attest standard and an auditing

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standard to better reflect the nature of the work being performed. SSAE No. 16 contains the requirements for reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, and earlier implementation is permitted. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324. Once the new SAS becomes effective, it will replace the guidance for user auditors currently in AU section 324. SSAE No. 16 is based on the International Auditing and Assurance Standards Board's (IAASB's) International Standard on Assurance Engagements No. 3402, *Assurance Reports on Controls at a Service Organization*, and the new SAS is based on the IAASB's International Standard on Auditing (ISA) 402, *Audit Considerations Relating to an Entity Using a Service Organization*.

.173 The AICPA is in the process of overhauling and rewriting the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (commonly known as the SAS No. 70 guide). Also, to address reporting on a service provider's controls over subject matter other than financial reporting, the AICPA is developing a new Audit Guide, *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*. Both guides are expected to be available for sale in early 2011. The AICPA is also in the process of drafting communication materials that will help auditors, clients, and users understand the three types of service organization control (SOC) reports (formerly SAS No. 70 reports) to be used for reporting on these engagements.

	Title	*Description*
SOC 1	*Report on Controls at a Service Organization Relevant to User Entities' Internal Control over Financial Reporting*	To be used only in circumstances when the service organization's services and controls affect the internal control over financial reporting for the entities that use the service.
SOC 2	*Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*	The purpose is to convey trust and assurance to users of the system that the service organization has deployed an effective control system to effectively mitigate operational and compliance risks that the system may represent to its users.
SOC 3	*Trust Services Report*	These reports are designed to meet the needs of users who want assurance on the controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy of a system but do not have the need for the level of detail provided in an SOC 2 report. These reports are general use reports and can be freely distributed or posted on a website as a seal.

Compilation and Review Engagements

.174 The AICPA developed a brand new guide, *Compilation and Review Engagements*, which provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Compilation and Review Engagements* (AICPA, *Professional Standards*, vol. 2). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

Accounting Issues and Developments

Accounting Standard Update No. 2009-17

.175 For calendar year entities, 2010 is the first year of application of FASB Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*, which changes how to determine when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. FASB Statement No. 167 was incorporated into FASB ASC through ASU No. 2009-17, *Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities.* This statement is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited.

.176 The determination of whether a company is required to consolidate an entity is based on, among other things, an entity's purpose and design and a company's ability to direct the activities of the entity that most significantly impact the entity's economic performance. This statement also amends consolidation of variable interest entities (VIE) guidance to eliminate the quantitative approach previously required for determining the primary beneficiary of a VIE, which was based on determining which enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both.

.177 Entities will be required to provide additional disclosures about involvement with VIEs and any significant changes in risk exposure due to that involvement. Entities also will be required to disclose how involvement with a VIE affects the entity's financial statements.

.178 FASB Statement No. 167 retains the scope of previous VIE consolidation accounting guidance, with the addition of entities previously considered qualifying special purpose entities because the concept of these entities was eliminated in FASB Statement No. 166, *Accounting for Transfers of Financial Assets—an amendment of FASB Statement No. 140,* which was incorporated into FASB ASC by ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*.

.179 This statement also discusses the objectives of its required disclosures and notes that an entity may need to supplement the minimum required disclosures to meet these objectives. The objectives are for the financial statement users to have an understanding of the following:

- The significant judgments and assumptions made by an enterprise in determining whether it must consolidate a VIE or disclose information about its involvement in a VIE, or both
- The nature of restrictions on a consolidated VIE's assets and on the settlement of its liabilities reported by an enterprise in its statement of financial position, including the carrying amounts of such assets and liabilities
- The nature of, and changes in, the risks associated with an enterprise's involvement with the VIE
- How an enterprise's involvement with the VIE affects the enterprise's financial position, financial performance, and cash flows

.180 ASU No. 2010-10, *Consolidation (Topic 810): Amendments for Certain Investment Funds*, was issued in February 2010 to defer the consolidation requirements contained in FASB Statement No. 167 for a reporting entity's interest in certain investment funds so that FASB and the International Accounting Standards Board (IASB) could develop consistent guidance on principal and agent relationships as part of their joint consolidation project. The deferral applies to a reporting entity's interest in an entity that has all the attributes of an investment company or for which it is industry practice to apply measurement principles for financial reporting purposes that are consistent with those followed by investment companies. It also applies to a reporting entity's interest in an entity that is required to comply or operate in accordance with requirements similar to those in Rule 2a-7 of the 1940 Act for registered money market funds. The deferral does not apply in situations when a reporting entity has the explicit or implicit obligation to fund losses of an entity that could potentially be significant to the entity. An entity that qualifies for the deferral will continue to be assessed

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under the overall guidance on the consolidation of VIEs in FASB ASC 810-10, before FASB Statement No. 167 amendments, or other applicable consolidation guidance.

.181 ASU No. 2010-10 does not defer the disclosure requirements from FASB Statement No. 167. The effective date of this guidance coincides with the effective date of FASB Statement No. 167 (the beginning of a reporting entity's first annual period that begins after November 15, 2009, and for interim periods within that first annual reporting period) and early application is not permitted.

ASU No. 2009-16

.182 Calendar year entities must also start applying the provisions of FASB Statement No. 166 in 2010. FASB Statement No. 166, which is a revision to FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, requires more information about transfers of financial assets, including securitization transactions, and those circumstances in which entities have continuing exposure to the risks related to transferred financial assets. FASB Statement No. 166 was incorporated into FASB ASC by ASU No. 2009-16 and is discussed in FASB ASC 860, *Transfers and Servicing*. It eliminates the concept of a qualifying special purpose entity, changes the requirements for derecognizing financial assets, and requires additional disclosures. The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial statements about a transfer of financial assets; the effects of a transfer on its financial position, financial performance, and cash flows; and a transferor's continuing involvement, if any, in transferred financial assets. It is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009; for interim periods within that first annual reporting period; and for interim and annual reporting periods thereafter. Earlier application is prohibited. This statement must be applied to transfers occurring on or after the effective date; however, the disclosure provisions should be applied to transfers that occurred both before and after the effective date.

.183 Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special purpose entities (as defined under previous accounting standards) should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance.

.184 The primary objectives of the disclosure requirements of this guidance are to provide the financial statement users with a clear understanding of the following:

- A transferor's continuing involvement (as defined by the FASB ASC glossary), if any, with transferred financial assets
- The nature of any restrictions on assets reported by an entity in its statement of financial position that relate to a transferred financial asset, including the carrying amounts of those assets
- How servicing assets and servicing liabilities are reported under this pronouncement
- For transfers accounted for as sales when a transferor has continuing involvement with the transferred financial assets and for transfers of financial assets accounted for as secured borrowings, how the transfer of financial assets affects a transferor's financial position, financial performance, and cash flows

.185 These objectives must be met by the disclosures, regardless of the specific requirements of the pronouncement. It may be the case that an entity provides greater detail than what is a required disclosure to meet these objectives, depending on the facts and circumstances.

Fair Value

.186 FASB ASC 820-10-20 defines fair value and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative investments increased in popularity and complexity.

Measuring Liabilities at Fair Value

.187 FASB issued ASU No. 2009-05, *Measuring Liabilities at Fair Value*, to increase the consistency in the application of FASB ASC 820 to liabilities. This ASU applies to all entities that measure liabilities at fair value under FASB ASC 820 and amends sections of FASB ASC 820-10.

.188 This ASU states that, in circumstances in which a quoted price in an active market for the identical liability is not available, fair value of the liability must be measured by either (*a*) a valuation technique that uses the quoted price of the identical liability when traded as an asset or quoted prices for similar liabilities, or similar liabilities when traded as assets, or (*b*) another valuation technique that is consistent with the principles of FASB ASC 820, such as an income approach or a market approach. The ASU clarifies that an entity is not required to factor restrictions on the transfer of the liability into the inputs of the fair value determination. Lastly, the ASU also clarifies that a quoted price in an active market for the identical liability, or an unadjusted quoted price in an active market for the identical liability, when traded as an asset, are level 1 measurements within the fair value hierarchy. The guidance in this ASU is effective for the first reporting period (including interim periods) beginning after its issuance in August 2009. The full text of the ASU can be accessed from FASB's website at www.fasb.org.

Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

.189 FASB issued ASU No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, because of the complexities and practical difficulties in estimating the fair value of alternative investments. It is applicable to all reporting entities that hold an investment that is required or permitted to be measured or disclosed at fair value on a recurring or nonrecurring basis, and as of the reporting entity's measurement date, if the investment both

- does not have a readily determinable fair value. The FASB ASC glossary states that an equity security has a *readily determinable fair value* if it meets any of the following conditions:
  - The fair value of any equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the SEC or in the OTC market, provided that those prices or quotations for the OTC market are publicly reported by NASDAQ or by Pink Sheets LLC. Restricted stock meets that definition if the restriction terminates within one year. (However, FASB ASC 820 observes that the valuation of a restricted security should be adjusted for the effect of the restriction, even if that restriction terminates within one year.)
  - The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to previously.
  - The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.
- is in an entity that has all of the attributes specified in FASB ASC 946-10-15-2 or, if one of those attributes is not met, is in an entity for which it is industry practice to issue financial statements using guidance that is consistent with the measurement principles in FASB ASC 946, *Financial Services—Investment Companies.*

.190 As a practical expedient, this ASU permits a reporting entity to measure the fair value of an investment within its scope on the basis of the NAV per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946 as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

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.191 This ASU also requires disclosures by major category of investment about the attributes of investments, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

.192 These amendments are effective for interim and annual periods ending after December 15, 2009 and are included in FASB ASC 820-10. An AICPA practice aid, *Alternative Investments—Audit Considerations* also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments.

.193 In December 2009, the AICPA issued sections .18–.27 of TIS section 2220, *Long-Term Investments* (AICPA, *Technical Practice Aids*), to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers compliment the guidance provided in ASU No. 2009-12.

.194 Topics covered in these questions and answers include the following:

- The circumstances when NAV may be used to estimate the fair value of investments as a practical expedient
- How to identify the unit of account for interests in alternative investments
- Considerations for determining whether the reported NAV has been calculated in a manner consistent with FASB ASC 946
- Examples of circumstances when an adjustment to the reported NAV may be necessary
- How to adjust the reported NAV when it is not as of the reporting entity's measurement date
- How to adjust the reported NAV when it has not been calculated in accordance with FASB ASC 946
- The determination of the appropriate level within the fair value hierarchy for NAV of alternative investments in relation to the ability to redeem the investment versus the actual redemption request for the investment
- The definition of *near term* for the purposes of determining the appropriate level within the fair value hierarchy
- The tailoring of disclosure categories to address the nature and risks of investments
- Some considerations for determining the fair value of alternative investments when not utilizing NAV as a practical expedient

.195 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurements Disclosures

.196 ASU No. 2010-06 was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers among the three levels and the underlying reasons for such transfers would be useful to financial statement users.

.197 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.198 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.199 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Subsequent Declines in Market Value

.200 The AICPA issued TIS section 9070.06, "Decline in Market Value of Assets Subsequent to the Balance Sheet Date" (AICPA, *Technical Practice Aids*), in June 2010 to provide guidance to accountants on the appropriate treatment of declines in the market value of an asset subsequent to the balance sheet date. Through references to FASB ASC 855-10, TIS section 9070.06 clarifies that an entity should only recognize the effects of conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date, but before financial statements are issued or are available to be issued, are specifically identified as an example of a nonrecognized subsequent event.

Business Combinations

.201 TIS section 6910.33, "Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination" (AICPA, *Technical Practice Aids*) was issued to provide guidance to investment companies involved in business combinations after the issuance of FASB Statement No. 141(R), *Business Combinations*. When investment companies engage in a business combination, shares of one company typically are exchanged for substantially all the shares or assets of another company (or companies). Most mergers of registered investment companies are structured as tax-free reorganizations. Following a business combination, portfolios of investment companies are often realigned, subject to tax limitations, to fit the objectives, strategies, and goals of the surviving company. Typically, shares of the acquiring fund are issued at an exchange ratio determined on the acquisition date, essentially equivalent to the acquiring fund's NAV per share divided by the NAV per share of the fund being acquired, both as calculated on the acquisition date. Adjusting the carrying amounts of assets and liabilities is usually unnecessary because virtually all assets of the combining investment companies (investments) are stated at fair value, in accordance with FASB ASC 820, and liabilities are generally short-term so that their carrying values approximate their fair values. However, conforming adjustments may be necessary when funds have different valuation policies (for example, valuing securities at the bid price versus the mean of the bid and asked price) in order to ensure that the exchange ratio is equitable to shareholders of both funds. Only one of the combining companies can be the legal survivor. In certain instances, it may not

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be clear which of the two funds constitutes the acquirer for financial reporting purposes. TIS section 6910.33 further discusses guidance for business combinations of investment companies, including the following:

- Determining the acquirer for financial reporting purposes
- Form N-14
- Tax implications
- Merger-related expenses
- Cost basis of acquired assets
- Required disclosures
- Illustrative financial statements and disclosures

.202 Recently issued TPAs can be accessed from www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Subsequent Events

.203 FASB Statement No. 165, which has been codified in FASB ASC 855, is effective for interim and annual periods ending after June 15, 2009. This statement is intended to establish general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or are available to be issued. It requires the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date (that is, whether that date represents the date the financial statements were issued or were available to be issued). The purpose of this disclosure is to alert all users of financial statements that an entity has not evaluated subsequent events after that date in the set of financial statements being presented.

.204 In particular, this statement sets forth the following:

- The period after the balance sheet date during which management of a reporting entity should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements
- The circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements
- The disclosures that an entity should make about events or transactions that occurred after the balance sheet date

.205 FASB states that this guidance should not result in significant changes in current practice with regard to the subsequent events that an entity reports, either through recognition or disclosure, in its financial statements. In September 2009, the AICPA issued TIS section 8700.01, "Effect of FASB ASC 855 on Accounting Guidance in AU Section 560" (AICPA, *Technical Practice Aids*), which notes that preparers of financial statements for nongovernmental entities are required to follow the accounting guidance in FASB ASC 855. Additionally, the accounting guidance contained in AU section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1), would no longer be applicable to audits of nongovernmental entities. Also in September 2009, the AICPA issued TIS section 8700.02, "Auditor's Responsibilities for Subsequent Events" (AICPA, *Technical Practice Aids*), to provide guidance related to the effect of this guidance on the auditor's responsibilities for subsequent events; this is discussed in the "Auditor Responsibilities for Subsequent Events" section of this alert. These questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

.206 In February 2010, FASB issued ASU No. 2010-09, *Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*, to address questions that arose in practice about potential conflicts between FASB ASC 855 and SEC guidance—specifically, the requirements to disclose the date that the financial statements are issued. This ASU also addresses the intended breadth of the reissuance disclosure provision related to subsequent events.

.207 ASU No. 2010-09 requires an entity that is an SEC filer or a conduit bond obligor for conduit debt securities that are traded in a public market to evaluate subsequent events through the date the financial statements are issued. All other entities must evaluate subsequent events through the date the financial statements are available to be issued. Further, an entity that is an SEC filer is not required to disclose the date through which subsequent events have been evaluated. Lastly, only non-SEC filers are required to disclose in the revised financial statements the dates through which subsequent events have been evaluated in both the issued or available-to-be-issued financial statements and the revised financial statements. Revised financial statements are considered reissued financial statements.

.208 The amendments in ASU No. 2010-09 are effective upon issuance, except for the use of the issued date for conduit bond obligors. That amendment is effective for interim or annual periods ending after June 15, 2010.

Accounting for Uncertainty in Income Taxes

.209 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*. In September 2009, FASB issued ASU No. 2009-06, *Income Taxes (Topic 740)—Implementation Guidance on Accounting for Uncertainty in Income Taxes and Disclosure Amendments for Nonpublic Entities*. This update affects all nongovernmental entities, and the disclosure amendments only apply to nonpublic entities. The four main provisions of the ASU include the following:

- If income taxes paid by the entity are attributable to the entity, the transaction should be accounted for in accordance with the guidance on uncertainty in income taxes in FASB ASC 740, *Income Taxes*. If the taxes paid by the entity are attributable to the owners, the transaction should be accounted for as a transaction with the owners. Attribution should be based on the laws and regulations of the jurisdiction and should be made for each jurisdiction where the entity is subject to income taxes.
- Management's determination of the taxable status of the entity, including its status as a pass-through entity or tax-exempt not-for-profit entity, is a tax position subject to the standards required for accounting for uncertainty in income taxes.
- Regardless of the tax status of the reporting entity, the tax positions of all entities within a related group of entities must be considered.
- For nonpublic entities, it eliminates the disclosures of a tabular reconciliation of the total amount of unrecognized tax benefits at the beginning and end of the periods presented and the total amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate (see FASB ASC 740-10-50-15[a]–[b]).

.210 For entities that are currently applying the guidance on accounting for uncertainty in income taxes, this ASU is effective for interim and annual periods ending after September 15, 2009.

.211 In June 2010, to clarify some practice issues related to FASB ASC 740-10, the AICPA issued TIS section 5250.15, "Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions" (AICPA, *Technical Practice Aids*). TIS section 5250.15 clarifies that the disclosure requirements in paragraph 15(c)–(e) of FASB ASC 740-10-50 remain in effect (if applicable), regardless of whether an entity has any uncertain tax positions. Those disclosure requirements include the following:

- The total amounts of interest and penalties recognized in both the statement of operations and the statement of financial position
- For positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will significantly increase or decrease within 12 months of the reporting date, the nature of the uncertainty, the nature of the event that could occur in the next 12 months that would cause the change, and an estimate of the range of the reasonably possible change or a statement that an estimate of the range cannot be made

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- A description of tax years that remain subject to examination by major tax jurisdictions

.212 Recently issued technical questions and answers of the AICPA can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Accounting for Certain Distributions to Shareholders

.213 In January 2010, FASB issued ASU No. 2010-01, *Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*. This ASU affects entities that declare dividends to shareholders that may be paid in cash or shares at the election of the shareholders with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate. The amendments in this ASU clarify that the stock portion of the distribution that allows the shareholders to elect or receive cash or shares, with a potential limitation on the total amount of cash that all shareholders can elect to receive in the aggregate, is considered a share issuance. The intent is to eliminate observed diversity in practice. These amendments are effective for interim and annual periods ending on or after December 15, 2009, and should be applied on a retrospective basis.

FASB Statement No. 168

.214 FASB Statement No. 168, *The* FASB Accounting Standards Codification™ *and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162*, as codified in FASB ASC 105, *Generally Accepted Accounting Principles*, is effective for financial statements issued for interim and annual periods ending after September 15, 2009. On the effective date of FASB Statement No. 168, FASB ASC became the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC. FASB ASC superseded all then-existing, non-SEC accounting and reporting standards for nongovernmental entities. This new standard flattens the U.S. GAAP hierarchy to two levels: one that is authoritative (in FASB ASC) and one that is nonauthoritative (not in FASB ASC). Exceptions include all rules and interpretive releases of the SEC under the authority of federal securities laws, which are sources of authoritative U.S. GAAP for SEC registrants, and certain grandfathered guidance having an effective date before March 15, 1992. If an accounting change results from the application of this guidance, an entity should disclose the nature and reason for the change in accounting principle in its financial statements.

Referencing FASB ASC in Your Documentation

.215 You should consider how your entity will reference FASB ASC in your documentation (policies and procedures, technical memoranda, financial statements and filings, engagement working papers, and so on). It is only prudent to reflect current U.S. GAAP in your documentation. The FASB Notice to Constituents includes a section on referencing FASB ASC in footnotes and other documents. In this notice, FASB encourages the use of plain English to describe broad topic references in the future. For example, to refer to the requirements of the *Derivatives and Hedging* topic, they suggest a reference similar to "as required by the *Derivatives and Hedging* topic of the FASB *Accounting Standards Codification*." Conversely, FASB suggests using the detailed numerical referencing system in working papers, articles, textbooks, and related items.

.216 Also, because FASB ASC is not intended to change U.S. GAAP, the consistent use of references to only FASB ASC for all periods presented (including periods before the authoritative release of FASB ASC) is appropriate. It is prudent to expect that audit, attest, or compilation and review working papers associated with financial statements for a period ending after September 15, 2009, also would reflect FASB ASC because the underlying financial statements, which are the subjects of those engagements, reference FASB ASC.

.217 However, if your entity will continue to follow grandfathered guidance not included in FASB ASC, it would still be appropriate to reference those standards (and not FASB ASC). A listing of examples of grandfathered guidance can be found in FASB Statement No. 168.

.218 Examples of disclosures using references to FASB ASC can be found at the AICPA's dedicated FASB ASC website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/FASBAccountingStandardsCodification.aspx.

Postcodification FASB References

.219 In spring 2010, the AICPA judgmentally selected 50 SEC filers and reviewed their 2009 Form 10-Ks to understand what type of references are actually being used in practice. All financial statements reviewed were for those entities having a fiscal year-end between December 1, 2009, and January 31, 2010, when the FASB codification was fully effective for all of these entities. The entities selected comprised the following:

- Fourteen large accelerated filers (28 percent of the sample)
- Twenty accelerated filers (40 percent of the sample)
- Seven nonaccelerated filers (14 percent of the sample)
- Nine smaller reporting companies (18 percent of the sample)

.220 Of all the entities selected, 50 percent had gone to mostly plain English references in their annual financial statements. However, among these entities, in the "Summary of Significant Accounting Policies" section of the financial statements, many entities did still use specific references to either old FASB standards (pre-FASB Statement No. 168 standards or legacy standards) or specific ASUs, when appropriate. There did not seem to be much of a difference in this percentage among large accelerated filers, accelerated filers, and nonaccelerated filers. However, smaller reporting companies were less likely to use plain English (only 33 percent used plain English references).

.221 As for the remaining 50 percent of filers selected, they chose to use either FASB ASC-specific references (36 percent) or some sort of dual references (12 percent) between the precodification standards and new FASB ASC guidance. One entity continued to use the old FASB references and did not mention FASB ASC in its financial statements.

.222 For those entities using FASB ASC references, most only referenced to the topic level and did not go down to the subtopic or section level. For those using dual references, in most cases, the new FASB ASC topic was listed first, with the historical FASB reference noted parenthetically. See the following table for a full breakout of the results:

	Plain English References	*FASB ASC References*	*Dual References*	*Old FASB References*
Large Accelerated Filers	7	4	2	1
Accelerated Filers	12	6	2	0
Nonaccelerated Filers	3	3	1	0
Smaller Reporting Companies	3	5	1	0
Total Sample	25	18	6	1

.223 The sampling results make it clear that although both FASB and the SEC have stated that the use of plain English is most appropriate when dealing with financial statements and notes to financial statements, not everyone is there yet. It will be interesting to see if the plain English references trend continues upward once entities have had another full year to get used to FASB ASC. In addition, all new guidance issued in 2010 was issued through ASUs, and no legacy standards were issued. Therefore, we would expect that in 2010 filings, even the "Summary of Significant Accounting Policies" section of financial statements would no longer refer to any legacy standards.

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.224 We found that with the plain English references, some entities chose instead to say something like, "in accordance with the purchase method of accounting and as updated with FASB's April 2009 additional authoritative guidance for business combinations, we ...." Here the entity uses plain English but also makes it clear which new guidance it is following. This would be most important for those FASB changes with early adoption provisions to make it clear which method an entity used.

.225 FASB has stated that ASUs do not themselves carry any authority; rather, the updates made to the codification once the ASU is effective are authoritative. Therefore, entities would be wise to ensure that when they are referring to authoritative literature, use of either plain English or the FASB ASC references would be appropriate, rather than just naming the ASU that brought about the change in accounting.

.226 In addition, entities would want to be sure that they do not refer to any legacy standards in their 2010 financial statements. Because all changes made to the codification in 2010 were through ASUs, referring to legacy standards is no longer correct. For example, since the codification became effective, there have been several updates to the *Fair Value Measurements and Disclosures* topic. Therefore, referring to FASB Statement No. 157, *Fair Value Measurements*, is no longer accurate because this standard does not incorporate changes made since the codification became effective in 2009. We would expect that entities that used dual references to both the legacy standards and FASB ASC references would not continue to use those dual references in 2010 financial statements.

.227 Many entities also have a section of their notes to financial statements titled "Effect of Accounting Pronouncements Not Yet Adopted." In 2010, we would expect the title of this section to change to something like "Effect of Authoritative Accounting Guidance Not Yet Adopted."

.228 It will be interesting to see if both public and nonpublic entities make any additional refinements or changes to their 2010 financial statements as we move into our first full year with FASB ASC. It is our understanding that the SEC may be issuing comment letters to those entities that are not properly reflecting the current state of U.S. GAAP in their financial statements, whether that be by using plain English or using the new FASB ASC references.

Convergence With International Financial Reporting Standards

.229 Since the signing of the Norwalk Agreement by FASB and the IASB, the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and IFRSs and eliminate the differences between them. In the Norwalk agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

SEC Work Plan for Consideration of IFRSs

.230 In February 2010, the SEC issued Release No. 33-9109, *Commission Statement in Support of Convergence and Global Accounting Standards*. This release provides an update to the SEC's roadmap on its consideration of global accounting standards, including a confirmation of its continued support for the convergence of U.S. GAAP and IFRSs in order to narrow the differences between the two sets of standards. The SEC believes that a more comprehensive work plan is necessary to lay out transparently the work that must be done to support a decision on the appropriate course to incorporate IFRSs into the U.S. financial reporting system for U.S. issuers, including the scope, time frame, and methodology for any such transition. Therefore, the SEC has indicated that it will carefully consider and deliberate whether these changes are in the best interest of U.S. investors and markets.

.231 The SEC directed its staff to execute a work plan, the results of which will aid the SEC in its evaluation of the impact that the use of IFRSs by U.S. entities would have on the U.S. securities market. The work plan includes consideration of IFRSs, both as they currently exist and after the completion of the various convergence projects underway by FASB and the IASB. Among other things, the work plan addresses some of the comments and concerns received on the roadmap, including the following:

- Sufficient development and application of IFRSs for the U.S. reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRSs
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

.232 IFRS lacks broad guidance for certain industries, including for investment companies. The roadmap excluded investment companies registered under the 1940 Act and certain other entities that are required to file or furnish certain types of financial reports (for example, broker-dealers). The comment letters received gave this exclusion a mixed reaction. Due to these varying opinions, the SEC staff will analyze possible approaches for financial reporting requirements for broker-dealers and investment companies, should the SEC determine in the future to incorporate IFRS into the U.S. financial reporting system. The SEC staff will assess the effects of such incorporation on broker-dealers, investment companies, and investors, including whether IFRS includes sufficient standards, and the extent of, logistics for, and estimated time necessary to undertake any changes, should broker-dealers and investment companies be included in the scope any potential SEC decision. The SEC staff will also evaluate the effect on investors of excluding broker-dealers and investment companies from the scope of any potential SEC decision.

.233 Beginning no later than October 2010, and frequently thereafter, the SEC staff will provide public progress reports on the work plan, as well as the status of the FASB and IASB convergence projects, until the work is complete. By 2011, assuming completion of these convergence projects and the staff's work plan, the SEC will decide whether to incorporate IFRSs into the U.S. financial reporting system and, if so, when and how. Commenters provided feedback on the timing discussed in the roadmap, suggesting that a four or five year time frame would be necessary to successfully implement a change in their financial reporting systems to incorporate IFRSs. Under that assumption, if the SEC determines in 2011 to incorporate IFRSs into the U.S. financial reporting system, the first time that U.S. entities would report under such a system would be no earlier than 2015. This timeline will be further evaluated as part of the work plan. The work plan is included as an appendix at the end of Release No. 33-9109 and also can be found on the SEC's website at www.sec.gov.

.234 In August 2010, the SEC issued two releases (Release Nos. 33-9133 and 33-9134, *Notice of Solicitation of Public Comment on Consideration of Incorporating IFRS Into the Financial Reporting System for U.S. Issuers*) to solicit public comment on its ongoing consideration of incorporating IFRSs into the financial reporting system for U.S. issuers. The first release contains requests for comment on three topics derived from the work plan that are related to the potential impact on investors. The second release contains requests for comment on three topics, also derived from the work plan, that are related to the potential impact on U.S. issuers. All comments will be available on the SEC's website.

International Financial Reporting Standard for Small and Medium-sized Entities

.235 The IASB issued *International Financial Reporting Standard for Small and Medium-sized Entities* (*IFRS for SMEs*) to be a self-contained global accounting and financial reporting standard applicable to the general purpose financial statements of, and other financial reporting by, entities that are known in many countries as SMEs. *IFRS for SMEs* is intended to be used by entities that publish general purpose financial statements for external users and do not have public accountability.

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.236 The AICPA Governing Council recognizes the IASB as an accounting body for purposes of establishing international financial accounting and reporting principles. This amendment to appendix A of AICPA Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202 par. .01), and Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01), gives AICPA members the option to use IFRSs as an alternative to U.S. GAAP. As such, a key professional barrier to using IFRSs and, therefore, *IFRS for SMEs* has been removed. CPAs may need to check with their state boards of accountancy to determine the status of reporting on financial statements prepared in accordance with *IFRS for SMEs* within their individual state. Any remaining barriers may come in the form of unwillingness by a private company's financial statement users to accept financial statements prepared under *IFRS for SMEs*, and a private company's expenditure of money, time and effort to convert to *IFRS for SMEs*.

.237 Information about IFRSs and *IFRS for SMEs* can be found at www.ifrs.com. Additionally, to help its membership, the AICPA has developed an IFRS for SMEs—U.S. GAAP Comparison Wiki. The purpose of the Wiki is to provide a detailed and comprehensive comparison of *IFRS for SMEs* with corresponding requirements of U.S. GAAP. But it is more than just a comparison resource—it is a wiki. That means it is a collaborative, ongoing work in progress for anyone to contribute to and use. The Wiki is found at http://wiki.ifrs.com/.

.238 Entities interested in *IFRS for SMEs* or possibly adopting the standard may find it helpful to take the following actions:

- *Monitor the efforts of the AICPA/FAF/NASBA "Blue-Ribbon" Panel on Standard Setting for Private Companies*. For more information about the panel, go to www.fasb.org/cs/ContentServer?c=Page&pagename=FASB%2FPage%2FSectionPage&cid=1176156684820.
- *Monitor convergence efforts of FASB and the IASB*.
- *Stay informed on SEC developments*. Public companies will be directly affected by the SEC's decision to adopt IASB standards. The future of private company reporting will also likely be affected by an SEC mandate to adopt IFRSs.
- *Develop a high-level analysis of the potential impact on accounting policies, processes and systems, contracts, legal agreements, and financing and tax structures.*

Private Company Financial Reporting

.239 The AICPA and the Financial Accounting Foundation (FAF) established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel also is sponsored by the National Association of State Boards of Accountancy. The "blue-ribbon panel" will provide recommendations through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies are needed. The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities taking more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries. The panel's issued report will be made available to the public, and the resulting action plan is expected to be exposed for public comment prior to that plan being finalized. The panel will issue a report containing its recommendations to the FAF board of trustees in January 2011. The report will be publicly available, and the resulting action plan is expected to be exposed for public comment prior to the plan being finalized.

.240 During the July 2010 meeting of the panel, seven alternative models for private company financial reporting were discussed. Models based on IFRSs and a model that would have resulted in no change to private company financial reporting were eliminated. All remaining models would result in differences in GAAP for private and public entities; the main focus of the panel moving forward will be to select a model that is relevant to users of private company financial reports because this has become the overriding issue. The three primary models the panel agreed to focus on going forward are U.S. GAAP with Exclusions for Private Companies—with enhancements; U.S. GAAP—Baseline GAAP with Public Company Add-Ons; and

Separate, Stand-Alone GAAP Based on Current U.S. GAAP. Most of the panel members also expressed their discontent with the current make-up of FASB and its heavy, but appropriate, focus on public companies. This led to another key discussion topic: the structure of whatever model is chosen—the current FASB; a restructured FASB (with greater private company representation); or a new, separate Private Company Standards Board under the oversight of the FAF.

Recent Pronouncements

.241 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The PCAOB establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.242 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance

Statement on Auditing Standards (SAS) No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*, vol. 1). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, vol. 1, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 550) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial

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Recent Auditing and Attestation Pronouncements and Related Guidance	
	statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801) Issue Date: December 2009 (Applicable to audits conducted in accordance with GAAS)	This standard amends AU section 801 to reflect changes in the compliance audit environment and incorporates the risk assessment standards. It requires the auditor to adapt and apply the AU sections of the AICPA's *Professional Standards* to compliance audits and provides guidance on how to do so. It is effective for compliance audits for fiscal periods ending on or after June 15, 2010. Earlier application is permitted.
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, vol. 1, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*, vol. 1), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.
Interpretation No. 1, "Reporting Under Section 112 of the Federal Deposit Insurance Corporation Improvement Act," of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*, vol. 1, AT sec. 9501 par. .01–.07) Issue Date: September 2010 (Interpretive publication)	For insured depository institutions (IDI) that require an examination of internal controls at the IDI level, this interpretation addresses whether the auditor can meet the integrated audit requirement when an IDI does not prepare financial statements for external distribution and, if so, how the auditor can report on the effectiveness of the IDI's internal control over financial reporting.
Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 15, *Audit Evidence* (subject to approval by the Securities and Exchange Commission [SEC]) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard explains what constitutes audit evidence and establishes requirements for designing and performing audit procedures to obtain sufficient appropriate audit evidence to support the opinion expressed in the auditor's report.
PCAOB Auditing Standard No. 14, *Evaluating Audit Results* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted	This standard establishes requirements regarding the auditor's evaluation of audit results and determination of whether the auditor has obtained sufficient appropriate audit evidence. The evaluation process set forth in this standard includes, among other things, evaluation of misstatements identified during the audit; the overall presentation of the financial statements, including disclosures; and the

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
in accordance with PCAOB standards)	potential for management bias in the financial statements.
PCAOB Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements for responding to the risks of material misstatement in financial statements through the general conduct of the audit and performing audit procedures regarding significant accounts and disclosures.
PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding the process of identifying and assessing risks of material misstatement of the financial statements. The risk assessment process discussed in the standard includes information-gathering procedures to identify risks and an analysis of the identified risks.
PCAOB Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard describes the auditor's responsibilities for consideration of materiality in planning and performing an audit.
PCAOB Auditing Standard No. 10, *Supervision of the Audit Engagement* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard sets forth requirements for supervision of the audit engagement, including, in particular, supervising the work of engagement team members. It applies to the engagement partner and to other engagement team members who assist the engagement partner with supervision.
PCAOB Auditing Standard No. 9, *Audit Planning* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard establishes requirements regarding planning an audit, including assessing matters that are important to the audit, and establishing an appropriate audit strategy and audit plan.
PCAOB Auditing Standard No. 8, *Audit Risk* (subject to approval by the SEC) Issue Date: August 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This standard discusses the auditor's consideration of audit risk in an audit of financial statements as part of an integrated audit or an audit of financial statements only. It describes the components of audit risk and the auditor's responsibilities for reducing audit risk to an appropriately low level in order to obtain reasonable assurance that the financial statements are free of material misstatement.
PCAOB Auditing Standard No.	This standard and its related amendments supersede the interim

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7, *Engagement Quality Review* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards) Issue Date: January 2010 (Applicable to audits conducted in accordance with PCAOB standards)	concurring partner review requirements and update the interim quality control standards. An engagement quality review and concurring approval of issuance are required for each audit engagement and for each engagement to review interim financial information conducted pursuant to the standards of the PCAOB. The standard provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion about the engagement. It is effective for engagement quality reviews of audits and interim reviews for fiscal years that began on or after December 15, 2009.
PCAOB Staff Question and Answer, *Auditing Standard No. 7,* Engagement Quality Review (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 100.10) Issue Date: February 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This staff question and answer provides further implementation guidance on the documentation requirements of Auditing Standard No. 7 in light of comments the SEC received during its comment period.
PCAOB Staff Audit Practice Alert (PA) No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.06) Issue Date: July 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert is intended to remind registered public accounting firms of their obligations when using the work of other firms or using assistants engaged from outside the firm. The alert was prompted by observations by the PCAOB that a number of registered public accounting firms located within the United States have been issuing reports on financial statements filed by issuers that have substantially all of their operations outside of the United States, and some of these firms may not be conducting those audits in accordance with PCAOB standards.
PCAOB Staff Audit PA No. 5, *Auditor Considerations Regarding Significant Unusual Transactions* (AICPA, *PCAOB Standards and Related Rules*, PCAOB Staff Guidance, sec. 400.05) Issue Date: April 2010 (Applicable to audits conducted in accordance with PCAOB standards)	This alert explains that significant unusual transactions, especially those close to period-end that pose difficult substance over form questions, can provide opportunities for entities to engage in fraudulent financial reporting. This staff audit practice alert is designed to remind auditors of public companies about their responsibilities to assess and respond to the risk of material misstatement of the financial statements due to error or fraud posed by significant unusual transactions.

Recent ASUs

.243 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2010-24, *Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content

labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) ***Accounting Standards Codification*** **(ASC)**	
Accounting Standards Update (ASU) No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
Liabilities Area of FASB ASC	
ASU No. 2009-15 (October 2009)	*Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing—a consensus of the FASB Emerging Issues Task Force*
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2009-13 (October 2009)	*Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
Broad Transactions Area of FASB ASC	
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2009-17 (December 2009)	*Consolidations (Topic 810): Improvements to Financial Reporting by Enterprises Involved with Variable Interest Entities*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2009-12 (September 2009)	*Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*

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Recent Accounting Standards Updates	
ASU No. 2009-16 (December 2009)	*Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-03 (January 2010)	*Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-24 (August 2010)	*Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-23 (August 2010)	*Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-07 (January 2010)	*Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*
ASU No. 2009-14 (October 2009)	*Software (Topic 985): Certain Revenue Arrangements That Include Software Elements—a consensus of the FASB Emerging Issues Task Force*

Recently Issued Technical Questions and Answers

.244 The following table presents a list of nonauthoritative accounting and audit and attest technical questions and answers recently issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

***Recently Issued Technical Questions and Answers* (AICPA, *Technical Practice Aids*)**	
Accounting	
Technical Questions and Answers (TIS) section 6910.18 (amended October 2010)	"Disclosure of an Investment in an Issuer When One or More Securities and/or One or More Derivatives are Held"
TIS section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"

(continued)

Recently Issued Technical Questions and Answers **(AICPA, *Technical Practice Aids*)**	
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments"
TIS section 6910.33 (December 2009)	"Certain Financial Reporting, Disclosure, Regulatory, and Tax Considerations When Preparing Financial Statements of Investment Companies Involved in a Business Combination"
TIS section 2220.27 (December 2009)	"Determining Fair Value of Investments When the Practical Expedient Is Not Used or Is Not Available"
TIS section 2220.26 (December 2009)	"Categorization of Investments for Disclosure Purposes"
TIS section 2220.25 (December 2009)	"Impact of 'Near Term' on Classification Within Fair Value Hierarchy"
TIS section 2220.24 (December 2009)	"Disclosures—Ability to Redeem Versus Actual Redemption Request"
TIS section 2220.23 (December 2009)	"Adjusting NAV When It Is Not Calculated Consistent With FASB ASC 946"
TIS section 2220.22 (December 2009)	"Adjusting NAV When It Is Not as of the Reporting Entity's Measurement Date"
TIS section 2220.21 (December 2009)	"Determining Whether an Adjustment to NAV Is Necessary"
TIS section 2220.20 (December 2009)	"Determining Whether NAV Is Calculated Consistent With FASB ASC 946, *Financial Services—Investment Companies*"

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Recently Issued Technical Questions and Answers **(AICPA, *Technical Practice Aids*)**	
TIS section 2220.19 (December 2009)	"Unit of Account"
TIS section 2220.18 (December 2009)	"Applicability of Practical Expedient"
TIS section 6910.32 (July 2009)	"Additional Financial Statement Disclosures for Nonregistered Investment Partnerships When the Partnership Has Provided Guarantees Related to the Investee Fund's Debt"
TIS section 6910.31 (July 2009)	"The Nonregistered Investment Partnership's Method for Calculating Its Proportional Share of Any Investments Owned by an Investee Fund in Applying the '5 Percent Test' Described in TIS Section 6910.30"
TIS section 6910.30 (July 2009)	"Disclosure Requirements of Investments for Nonregistered Investment Partnerships When Their Interest in an Investee Fund Constitutes Less Than 5 Percent of the Nonregistered Investment Partnership's Net Assets"
TIS section 1600.04 (June 2009)	"Presentation of Assets at Current Values and Liabilities at Current Amounts in Personal Financial Statements"
TIS section 1500.07 (June 2009)	"Disclosure Concerning Subsequent Events in OCBOA Financial Statements"
Audit and Attest	
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"
TIS section 9110.16 (February 2010)	"Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions"
TIS section 8700.02 (September 2009)	"Auditor Responsibilities for Subsequent Events"
TIS section 8700.01 (September 2009)	"Effect of FASB ASC 855 on Accounting Guidance in AU Section 560"

Recent AICPA Independence and Ethics Developments

.245 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at (888) 777-7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.246 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3, "Performance of Nonattest Services" under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05). Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. The PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as "maintaining internal control" for the client.

.247 To address the possible inconsistency in Interpretation No. 101-3, the PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members better distinguish between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

On the Horizon

.248 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to the investment companies industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.249 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.250 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the past few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the ISAs issued by the IAASB. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, vol. 1, AU sec. 801), will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the first half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU sections 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* and 532, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1).

.251 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence" and

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the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Interim Financial Information

.252 In July 2010, the ASB issued two proposed SASs on interim financial information. The first, *Revised Applicability of Statement on Auditing Standards No. 116*, Interim Financial Information, is intended to revise paragraph 5 of SAS No. 116 (AICPA, *Professional Standards*, AU sec. 722), so that the guidance in SAS No. 116 would be applicable when the auditor audited the entity's latest annual financial statements and the appointment of another auditor to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. Currently, the guidance in SAS No. 116 is applicable when the auditor performs the audit of the latest annual financial statements and expects to be engaged to audit the current year financial statements (and, therefore, is not applicable when the auditor expects that a new auditor may be engaged for the current year). This proposed amendment would be effective for reviews of interim financial information for periods beginning after December 15, 2011, with early implementation permitted. Comments are due by October 8, 2010.

.253 The second proposal on interim financial information, *Interim Financial Information* (Redrafted), would supersede SAS No. 116 and represents the redrafting of the guidance to apply clarity drafting conventions. The main changes to existing standards are as follows:

- Replacement of the term *accountant* with *auditor*
- The change to paragraph 5 discussed in the prior paragraph
- Requirement of the auditor to issue a written report unless the review of the interim financial information is required by a third party and the third party does not require a written review report
- Allowance of oral reports for entities that are subject to external requirements to report in a manner that is substantially similar to the reporting required of issuers, pursuant to PCAOB standards
- Requirement for the auditor to perform procedures consistent with those required for acceptance of an engagement to audit financial statements
- Requirement for the review report to include a statement that the review of interim financial information was conducted in accordance with auditing standards generally accepted in the United States of America

.254 This proposed SAS would be effective for reviews of interim financial information for interim periods of fiscal years beginning on or after December 15, 2012. Comments for this proposed SAS are also due by October 8, 2010.

Exposure Drafts on Auditor's Reports

.255 The ASB issued three proposed SASs related to auditor's reports: *Forming an Opinion and Reporting on Financial Statements*, *Modifications to the Opinion in the Independent Auditor's Report*, and *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. These proposed standards are drafted with the ASB's clarity drafting conventions and are intended to converge with ISAs. The intent of issuing three separate SASs is to assist practitioners in identifying and applying the reporting requirements and guidance. The ASB has made various changes to the related ISAs to tailor them to the U.S.; however, these changes have not been substantial in nature.

.256 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Exposure Drafts on Special Considerations Audits

.257 Another exposure draft issued by the ASB contains two proposed SASs: *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* and *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement*. These proposed standards have been drafted with the clarity drafting conventions and are intended to converge with the equivalent ISAs. No meaningful differences exist between these proposed standards and the ISAs. *Special Considerations—Audits of Financial Statements Prepared in Accordance With Special Purpose Frameworks* addresses the application of GAAS to financial statements prepared under the cash, tax, regulatory, or contractual bases of accounting. It also replaces the term *other comprehensive basis of accounting* with *special purpose framework*.

.258 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts, or Items of a Financial Statement* introduces new planning, performance, and reporting requirements for these engagements. The proposed SAS also clarifies that a single financial statement and a specific element of a financial statement include the related notes.

.259 The comment period for the proposed SASs ended in December 2009. The proposed SASs are expected to be effective for audits of financial statements for periods ending on or after December 15, 2012. Auditors are encouraged to review the exposure draft and be alert for developments on this topic.

Auditing and Attestation Pipeline—Issuers

Confirmations

.260 The PCAOB has proposed a draft auditing standard on confirmations. A concept release was originally issued in April 2009 and received 24 comment letters. This proposed auditing standard, issued in July 2010, would strengthen the requirements under the current auditing standard, AU section 330, *The Confirmation Process* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), and replace it, upon final issuance of a standard and approval from the SEC. The proposed new standard

- requires confirmation procedures for specific accounts, such as receivables that arise from credit sales, loans, or other transactions, and also in response to significant risks that relate to the relevant assertions that can be adequately addressed by confirmation procedures.
- incorporates procedures in response to the risk of material misstatement, such as in the areas of investigating exceptions reflected on confirmation responses and evaluating nonresponses to confirmation requests.
- updates the confirmation guidance to reflect significant advances in technology and explains that confirmation responses received electronically (for example, by fax, e-mail, through an intermediary, or direct access) might involve additional risks relating to reliability. Therefore, the auditor must perform additional requirements.
- defines a confirmation response to include electronic or other media.
- enhances requirements when confirmation responses include disclaimers and restrictive language by requiring the auditor to evaluate the effect on the reliability of a confirmation response. Further, if the disclaimer or restrictive language causes doubts about the reliability of a confirmation response, the auditor should obtain additional appropriate audit evidence.

.261 In drafting this proposed standard, the PCAOB considered the guidance contained in ISA 505, *External Confirmations*, and the AICPA's proposed guidance on confirmations. This standard is anticipated to be effective for auditors for fiscal years ending on or after December 15, 2011.

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Communications With Audit Committees

.262 In March 2010, the PCAOB proposed for comment an auditing standard on *Communications with Audit Committees* and a series of related amendments to its interim standards that are intended to (*a*) enhance the relevance and effectiveness of the communications between the auditor and the audit committee and (*b*) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit. Two of the new requirements would be for the auditor (*a*) to establish a mutual understanding of the terms of the audit engagement with the audit committee and to document that understanding in the engagement letter and (*b*) to evaluate the adequacy of two-way communication between the auditor and audit committee. Additionally, the proposal also includes requirements for the auditor to communicate with the audit committee regarding the following:

- An overview of the audit strategy and timing of the audit, including a discussion of significant risks; the use of the internal audit function; and the roles, responsibilities, and location of firms participating in the audit
- Critical accounting policies, practices, and estimates
- The auditor's evaluation of the entity's ability to continue as a going concern

.263 The proposed standard would become effective, subject to SEC approval, for audits of fiscal years beginning after December 15, 2010.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.264 The year 2010 has been a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Balance Sheet Netting
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Statement of comprehensive income
- Discontinued operations

.265 A progress report for the quarter ended March 31, 2010, highlighted the following topics: (*a*) on the financial instruments topic, the boards have reached different conclusions on significant technical issues that may affect the project timetable and (*b*) the boards agreed to explore an alternative approach to lessor accounting that may affect the project timetable of this topic. In March 2010, the exposure draft *Conceptual*

Framework for Financial Reporting was published for public comment. In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. Specifically, the boards were scheduled to expose for comment numerous major exposure drafts during the second quarter of 2010, and stakeholders voiced concern about their ability under those circumstances to provide high-quality input. The boards have developed a modified strategy to accommodate these concerns by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate consultation document seeking stakeholder input about effective dates and transition methods.

.266 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. The boards also decided to issue separate exposure drafts to address differences in the two sets of standards on balance sheet netting of derivative contracts and other financial instruments. The IASB has also made its projects on improved disclosures about derecognized assets and other off balance sheet risks, consolidations, and insurance contracts priorities. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, have been extended into the second half of 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively affect the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the U.S. financial system.

.267 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Comprehensive Income Exposure Draft

.268 In May 2010, FASB issued a proposed ASU on comprehensive income that would require an entity to report total comprehensive income in a continuous financial statement in two parts: net income and other comprehensive income. In that financial statement, the components of net income and the components of other comprehensive income should be displayed. The proposed ASU is intended to simplify how comprehensive income is reported by eliminating two options for how items of comprehensive income are displayed. The proposed ASU contains illustrative examples of the revised financial statement. This proposed ASU is the result of a joint project as part of IFRSs and U.S. GAAP convergence, and the IASB has separately issued a similar document. The proposed amendments would be applied on a fully retrospective basis to improve comparability between reporting periods. Further, because compliance with the proposed amendments is already permitted, early adoption would be permitted. FASB plans to align the effective date with the effective date of the amendments in the proposed ASU on financial instruments. The IASB and FASB aim to finalize an improved and converged standard on other comprehensive income in the fourth quarter of 2010.

Financial Instruments Exposure Draft

.269 Also, in May 2010, FASB issued a proposed ASU on accounting for financial instruments, derivative instruments, and hedging activities. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments; removes the threshold for recognizing credit impairments, creating a single credit impairment model for both loans and debt securities; and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.
- Changes in fair value of equity securities, certain hybrid instruments, and financial instruments that can be prepaid in such a way that the holder would not recover substantially all of its investment

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would be recognized in net income each reporting period regardless of an entity's business strategy for those financial instruments.

- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, a reconciliation from amortized cost to fair value would be required on the statement of position; with the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period. Therefore, net income will remain relatively unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period.
- The existing "probable" threshold for recognizing impairments on loans would be removed. (Currently, FASB ASC 310-10-35-4 states that the concept in U.S. GAAP is that impairment of receivables [including loans] should be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements. *Probable* is defined by FASB ASC 310-10-20 as when the future event or events are likely to occur.)
- For changes in the value of financial instruments measured through other comprehensive income, an entity is required to determine if a credit impairment is appropriate at the end of each reporting period based on information related to past events and existing economic conditions. An entity would recognize in net income the loss related to the amount of credit impairment for all contractual amounts the entity does not expect to collect.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected, which would better reflect a financial instrument's interest yield.
- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.
- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.270 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments).

.271 For investment companies, the areas of focus are the changes to accounting for financial liabilities, money market funds, and transaction costs. The proposed guidance would require financial liabilities of investment companies to be measured at fair value with changes in fair value recognized as a net increase (decrease) in net assets. Neither the option to report changes in the fair value of a qualifying financial asset or financial liability in other comprehensive income nor the amortized cost option for qualifying financial liabilities would be available to an investment company. FASB believes that recognizing changes in fair value in net assets resulting from operations would provide the most relevant information for users of their financial statements. The proposed guidance would also require money market funds that comply with Rule 2a-7 of the 1940 Act to measure their investments at fair value rather than amortized cost. Further, the proposal to expense all transaction costs rather than capitalize certain costs as part of the initial fair value measurement

of financial assets would be a significant change for investment companies that would affect their expense ratios. These proposed changes would affect the guidance contained in subtopics 320, 323, and 405 of FASB ASC 946.

.272 This proposed ASU was not issued jointly with the IASB and does not contain converged guidance; however, the goal still remains for both boards to issue comprehensive improvements to foster international comparability of financial information about financial instruments. The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009. The IASB also issued two exposure drafts on amortized cost and impairment and fair value option for financial liabilities in late 2009 and mid-2010, respectively; the third topic, hedge accounting, is still being deliberated by the IASB, and an exposure draft is expected in the near term. The boards have stated that they will consider together the comment letters and other feedback received on each board's exposure drafts in an effort to reconcile their differences in ways that foster improvement and convergence.

.273 The effective date of these amendments will be established upon issuance of the final ASU, which is expected in the second quarter of 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional four years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

.274 FASB has issued frequently asked questions for the proposed ASU to clarify the proposal by answering common questions received about the proposed guidance. This document can be accessed at www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157295447.

Revenue Recognition Exposure Draft

.275 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from Contracts with Customers*, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.276 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities (for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (*performance obligation* is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).

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- determine the transaction price (*transaction price* is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.277 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*) recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

.278 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the boards plan to invite additional comment through a separate consultation on how best to transition over to the new standards. Therefore, no expected specific effective date is stated at this point. Comments on the exposure draft are due on October 22, 2010. This topic is considered by many to be the most pervasive of any FASB has ever worked on. The reader is encouraged to review the exposure draft, consider if it is operational to you or your clients' common revenue transactions, and share any resulting concerns with FASB. The boards also anticipate holding public roundtable meetings after the end of the comment period.

Fair Value Exposure Draft

.279 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.280 The first two of these significant amendments are intended to clarify the application of existing fair value measurement guidance. The last three of these significant amendments would change a particular principle of fair value guidance.

.281 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines *highest and best use* as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or

the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values do not depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.282 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

.283 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to interest rate risk, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice. However, they might affect the current practice for reporting entities that apply the in-use valuation premise more broadly.

.284 The proposed amendments regarding the application of blockage factors and other premiums and discounts in fair value measurements would make two changes to current guidance. Currently, under U.S. GAAP, use of a blockage factor in fair value measurements is only prohibited when fair value is measured using a quoted price for an asset or a liability (or similar assets or liabilities) in an active market. This would be level 1 within the fair value hierarchy. The first change from the proposed amendments is that a blockage factor is not relevant and, therefore, also should not be used when fair value is measured using a valuation technique that does not use a quoted price in an active market. This would be level 2 or level 3 within the fair value hierarchy. Second, the amendments specify that fair value measurements categorized within level 2 and level 3 take into account other premiums and discounts when market participants would consider those premiums or discounts when pricing an asset or a liability, consistent with the unit of account for that asset or liability. Examples include a control premium or a noncontrolling interest discount. These proposed amendments may affect current practice for any reporting entities applying a blockage factor in fair value measurements that is measured using quoted prices and categorized within level 2 or level 3 of the fair value hierarchy.

.285 Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

- The effect on a level 3 fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances (excluding unquoted equity instruments, as provided by FASB's financial instruments exposure draft discussed previously)
- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use

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- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

.286 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. A final ASU is expected to be issued in the first quarter of 2011.

Financial Statement Presentation Staff Draft

.287 FASB and the IASB are working together to establish a common standard that would improve how information is organized and presented in financial statements. This common standard is intended to address users' concerns that existing requirements permit too many alternative types of presentation and that information in financial statements is highly aggregated and inconsistently presented, making it difficult to fully understand the relationship between an entity's financial statements and its financial results. In 2008, a discussion paper was issued by the boards that outlined the proposed principles for presenting financial statements in a way that portrays a cohesive financial picture of an entity.

.288 Given the magnitude of this project, the expected implementation costs, and the substantial effects it will have on financial statement presentation for many years to come, the boards decided in May 2010 to modify the strategy for this project. Before finalizing an exposure draft, the boards decided to engage in additional outreach activities that focus on the perceived benefits and costs of the proposals and the implications of the proposals for financial reporting by financial service entities. The boards plan on discussing these two areas of focus with preparers and users of financial statements. This outreach will be based on a rough draft of a proposed standard, known as a *staff draft*, and reflects the cumulative tentative decisions made by the boards, concluding with their joint meeting in April 2010. This staff draft was made publicly available solely for this purpose.

.289 The proposals in this project would be applicable to all entities, except a benefit plan within the scope of FASB ASC 960, *Plan Accounting—Defined Benefit Pension Plans*; 962, *Plan Accounting—Defined Contribution Pension Plans*; and 965, *Plan Accounting—Health and Welfare Benefit Plans* or IAS 26, *Accounting and Reporting by Retirement Benefit Plans*. The two core financial statement principles in this proposal are cohesiveness and disaggregation. A common structure for the statements of financial position, comprehensive income, and cash flows would be established in the form of required sections, categories or subcategory, and related subtotals. Some proposed specific changes in the classification and format of financial statements include the following:

- Related information would be displayed in the same sections, categories, and subcategory in each statement so that information is more easily associated.
- Presentation of business and financing activities would be separated as follows:
  - The business section would include items that are part of an entity's daily operations and other income generating activities.
  - The financing section would include items that are part of an entity's activities to obtain (or repay) capital.
- Discontinued operations and income taxes would be presented in their own separate sections.
- The statement of changes in equity would not include the sections and categories used in the other statements because that statement presents information solely about changes in items classified in the equity category in the statement of financial position.

.290 Further, FASB plans to propose some changes that are already required by IAS 1, *Presentation of Financial Statements*. The proposal would define, and provide the requirements for a complete set of financial statements. Currently, a complete set of financial statements for the period is defined only in the FASB Concepts Statements. An entity would also be required to present one period of comparative information. A *complete set of financial statements* would consist of, at a minimum, statements of financial position, comprehensive income, cash flows and changes in equity, and notes to financial statements for two periods (the current period and the previous period). Also, an opening statement of financial position would be part of a complete set of financial statements if an entity applies an accounting principle retrospectively, restates its financial statements, or reclassifies items in the financial statements.

.291 The boards' tentative decisions on financial statement presentations do differ in a few ways in relation to minimum line requirements for the statement of financial position, segment reporting, and net debt presentation. Of these three, the differing stance on segment reporting is the only significant difference. The boards now aim to issue an exposure draft in the first quarter of 2011 and a final improved and converged standard in the fourth quarter of 2011. Both the introduction to the staff draft and the staff draft can be accessed from FASB's website at www.fasb.org.

Investment Companies Joint Project

.292 FASB and the IASB also have a project on their agenda with the objective of providing comprehensive guidance for addressing whether an entity is an investment company and providing measurement requirements for an investment company's investments. The boards have reached the following decisions on this project:

- When preparing consolidated financial statements, the parent of an investment company (if it is not an investment company) should be prohibited from retaining the fair value accounting of the investment company.
- A parent of an investment company is required to consolidate all entities that it controls, including those that are controlled by an investment company subsidiary, unless that parent is an investment company itself.
- If a reporting entity has an interest in an investment company that it accounts for using the equity method, it should retain the fair value accounting of the investment company.

.293 The boards have tentatively decided on the criteria to classify as an investment company. These criteria are as follows: (*a*) the express business purpose is investing for current income, capital appreciation, or both; (*b*) potential exit strategies and a defined time (or range of dates) for which to exit the investment have been identified; (*c*) substantially all of the entity's activities are investment activities carried out for its express business purposes; (*d*) unit ownership; (*e*) pooling of funds; (*f*) the investments are managed and their performance evaluated (both internally and externally) on a fair value basis; (*g*) the entity is a reporting entity; and (*h*) any providers of debt to the investees of the entity do not have direct recourse to any of the entity's other investees.

.294 FASB has tentatively decided that an investment company must measure all of its investments at fair value. The IASB tentatively decided that an investment company must measure investments in entities that it controls at fair value through profit or loss. Further, an investment company should disclose whether it has provided any financial or other support to any of its controlled investees that it was not previously contractually required to provide and the nature and extent of any significant restrictions on the ability of its controlled investees to transfer funds to the investment company. An investment company should not be required to present summarized financial information for controlled investments.

.295 Regarding transition, FASB tentatively decided that an entity currently applying the guidance in FASB ASC 946 that no longer qualifies as an investment company should discontinue the application of that guidance. This change would be applied prospectively from the date the revised consolidation requirements are first applied. For investees that are required to be consolidated as a result of an entity no longer qualifying as an investment company, the entity should apply the same transition guidance for all other entities that will

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be required to be consolidated as a result of the revised consolidation requirements. Both boards tentatively decided that an entity that was not previously considered an investment company, but that would be under the new criteria, should recognize its investments in entities that it controls at fair value on the date that it first applies the revised consolidation requirements, with an adjustment made to retained earnings.

.296 An exposure draft is scheduled for release during the fourth quarter of 2010, with a final document expected in the second quarter of 2011. The boards specifically asked that it be clear that significant third-party investment is required for an entity to be an investment company.

Leases Exposure Draft

.297 During the third quarter of 2010, the IASB and FASB published for public comment joint proposals to improve the financial reporting of lease contracts. These proposals would result in a consistent approach to lease accounting for both lessees and lessors—a "right of use" approach. This would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, therefore providing more complete and useful information to investors and other users of financial statements. Currently, the accounting for a lease depends on its classification; an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRSs or U.S. GAAP, whereas a capital lease results in the lessee recognizing an asset and an obligation. Under the proposed guidance, lessees would only have one method of accounting for leases, which would produce more complete and comparable financial reporting in addition to reducing the opportunity to structure transactions to achieve a desired accounting outcome.

.298 The scope of the new lease guidance includes all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. Under this new guidance, all lessees would use a single method of accounting for all leases: an asset would be recognized representing the lessee's right to use the leased (underlying) asset for the lease term (the right-of-use asset), and a liability at the present value of the expected lease payments would also be recognized.

.299 A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either (*a*) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or (*b*) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach). The assets and liabilities recognized by both lessors and lessees would be measured on the basis that

- assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- a remeasurement is triggered when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

.300 For leases of 12 months or less, lessors and lessees would be able to apply simplified requirements. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. New disclosures would also be required.

.301 In early 2009, the boards issued a discussion paper on leases; this exposure draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors, regulators, and other interested parties since that discussion paper. The comment period is open until December 15, 2010. During the comment period, the boards will undertake further outreach activities, including public round-table meetings to ensure that the views of all interested parties are taken into consideration before the new standard is completed. Also, the boards will share and jointly consider all

comment letters received. A final standard is expected in the second quarter of 2011. The AICPA has developed questions and answers to highlight the important aspects of the proposals, which can be located at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/DownloadableDocuments/EDITED_LEASES_FAQ.pdf.

Insurance Contracts Discussion Paper

.302 In June 2010, the IASB issued an exposure draft of a proposed IFRS that would apply to all insurance contracts written by both insurance entities and noninsurance entities. Three months later, FASB issued a discussion paper to solicit broad-based input on how to improve, simplify, and converge the financial reporting requirements for insurance contracts. The solicited feedback is focused on (*a*) whether the IASB's proposal would be a sufficient improvement to U.S. GAAP to justify the cost of change; (*b*) whether the project goals of improvement, convergence, and simplification would be more effectively achieved by making targeted improvements to existing U.S. GAAP (rather than issuing comprehensive new guidance); and (*c*) certain critical accounting issues for which the preliminary views of FASB differ from the IASB's exposure draft. It is important to remember that although the project on insurance contracts is a joint project, it is not part of the boards' MoU.

.303 The discussion paper summarizes the key aspects of the IASB's exposure draft and compares the proposed changes with both the alternative preliminary views of FASB and the current guidance in FASB ASC 944, *Financial Services—Insurance*. FASB decided to issue a discussion paper rather than an exposure draft because of the following reasons:

- The extent of FASB's and the IASB's current accounting guidance for insurance contracts varies significantly; U.S. GAAP comprehensively addresses accounting for insurance contracts by insurance entities, whereas IFRSs do not have comprehensive guidance. Further, the boards have not explicitly evaluated whether the model proposed in the IASB's exposure draft would represent an improvement to U.S. GAAP.
- FASB has not determined whether one model or two models would result in more useful information about insurance contracts. FASB would like additional input from stakeholders on whether different types of insurance contracts warrant different recognition, measurement, and presentation and, if so, what criteria should be used for determining which, if any, types of insurance contracts would use each model.
- FASB is considering whether employer-provided health insurance should be included within the scope of the insurance contracts project and how recent U.S. health care reform may affect the application of the different approaches.

.304 The discussion paper also includes a listing of common elements of U.S. GAAP on insurance contracts that some stakeholders note could be improved. The appendix of the discussion paper compares the main areas of current U.S. GAAP for insurance contracts, the IASB's proposed approach, and FASB's preliminary views that differ from the proposed approach included in the IASB's exposure draft. Comments are due by mid-December 2010. Additionally, FASB and the IASB plan to host a series of public roundtable meetings in December 2010 to hear stakeholders' views. Readers should be alert for developments on this topic.

Auditing Considerations of Accounting Convergence

.305 Although the future of convergence between IASB and FASB accounting standards remains an unknown, discussions have already begun about the potential impact on auditors. Although auditors are accustomed to new standards, the nature and volume of these changes will likely pose new challenges. Among others, some of these potential challenges include the following:

- Training audit staff on a large amount of new accounting guidance that is based on an accounting approach (that is, principles based versus rules based)
- Developing, as necessary, any new internal audit guidance, such as firm methodology

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- Implementing any new resulting auditing rules
- Creating a new framework for documenting audit conclusions on a principles-based accounting approach
- Audit committees learning new accounting guidance to effectively perform their function

.306 In addition to the challenges auditors will face, the effects on preparers will also be great. At the time of this writing, it appears that the transition timeline to convergence will be relatively short; this will divert resources during the preparation of financial statements as entities focus on implementing the new principles, which may result in increased audit risk. Auditors, in addition to preparers, are also encouraged to remain current on developments of international accounting convergence.

FASB Accounting Pipeline

Disclosure of Certain Loss Contingencies

.307 In July 2010, FASB issued an exposure draft on the disclosure of certain loss contingencies in response to concerns from investors and other financial statement users that the current disclosures do not provide adequate and timely information to assess the likelihood, timing, and magnitude of future cash outflows associated with loss contingencies. The objective of these disclosures would be for an entity to disclose qualitative and quantitative information about loss contingencies to enable financial statement users to understand all of the following: the nature of the loss contingencies, their potential magnitude, and their potential timing (if known). Disclosure of certain remote loss contingencies would be required and, therefore, would expand the population of loss contingencies that are required to be disclosed. An entity would not consider the possibility of recoveries from insurance or other indemnification arrangements when assessing the materiality of loss contingencies to determine whether disclosure is required. Further, current qualitative disclosures would be enhanced by requiring additional disclosures. These additional required qualitative and quantitative disclosures include the following:

- For litigation contingencies, the contentions of the parties and how users can obtain more information about the litigation
- Publicly available quantitative information, such as the claim amount for asserted litigation contingencies; other relevant nonprivileged information; and, in some cases, information about possible recoveries from insurance and other sources
- For public entities, tabular reconciliations, by class, of recognized (accrued) loss contingencies that present the activity in the account during the period

.308 The amendments in this proposal would affect all entities. The exposure draft noted that FASB will continue to work with the PCAOB, the AICPA, and the American Bar Association (ABA) to identify and address any potential implications of the proposed amendments for auditing literature and the ABA's Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information. The proposed amendments would be effective for fiscal years ending after December 15, 2010, for public entities and in the first annual period beginning after December 15, 2010, for nonpublic entities. The comment period ended in September 2010.

Going Concern FASB Project

.309 Currently, the only guidance on going concern resides in the auditing literature, and this project's intention is to incorporate going concern guidance into U.S. GAAP. Specifically, this guidance would discuss the following:

- Preparation of financial statements as a going concern
- An entity's responsibility to evaluate its ability to continue as a going concern
- Disclosure requirements when financial statements are not prepared on a going concern basis

- Disclosure requirements when there is a substantial doubt about an entity's ability to continue as a going concern
- The adoption and application of the liquidation basis of accounting

.310 A revised exposure draft is expected to be issued in the fourth quarter of 2010, with a final ASU expected in the first quarter of 2011. FASB has decided that management should take into account available information about the foreseeable future, which is generally, but not limited to, 12 months from the end of the reporting period. Readers should be alert to developments on this topic.

Other Accounting Projects

.311 Additionally, FASB has the following projects underway:

- Troubled debt restructuring
- Disclosure framework
- Investment properties

CFTC On the Horizon

Depository Acknowledgement Letters

.312 In August 2010, the CFTC proposed amending Regulations 1.20, 1.26, and 30.7 concerning the acknowledgment letters that a FCM or derivatives clearing organization must obtain from any depository holding its segregated customer funds or funds of foreign futures or foreign options customers. The proposal sets out standard template acknowledgment letters that reaffirm and clarify the obligations depositories incur when accepting segregated customer funds. The comment period will last 30 days following publication in the *Federal Register*.

Investment of Funds Deposited With Clearing Organizations and FCMs

.313 In 2009, the CFTC issued an advance notice of proposed rulemaking seeking public comment on possible changes to its regulations regarding the investment of customer funds segregated pursuant to Section 4d of the Commodity Exchange Act and funds held in an account subject to Regulation 30.7. Comment letters received have been analyzed, and a formal proposal is being circulated for CFTC approval.

Dodd-Frank Act

.314 On July 21, 2010, the CFTC released the list of 30 areas of rulemaking to implement the Dodd-Frank Act. Some of these areas will require only one rule, while others may require more. The CFTC is required to complete these rules generally in 360 days, though some are required to be completed within 90, 180, or 270 days.

.315 The rule-writing areas have been divided into eight groups: Comprehensive Regulation of Swap Dealers & Major Swap Participants; Clearing; Trading; Data; Particular Products; Enforcement; Position Limits; and Other Titles.

.316 The CFTC is requesting input from the public on each of the rule-writing areas. Instructions for submitting views can be accessed on the individual rule-writing pages on the CFTC's website at www.cftc.gov/LawRegulation/OTCDerivatives/.

Agreed Upon Procedures Report

.317 CFTC staff is developing, in conjunction with industry and independent auditors, an "Agreed Upon Procedures" report for the segregation and secured amount schedules included in an FCM's annual audited

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financial report. The report is designed to provide greater assurance that FCMs are complying with the regulatory requirements surrounding the segregation and secured computations that are included in the annual report.

Resource Central

.318 The following are various resources that practitioners engaged in the investment companies industry may find beneficial.

Publications

.319 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *Investment Companies* (2010) (product no. 0126210 [paperback], DIN-XX [CD-ROM], or WIN-XX [online])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2010/11* (product no. 0223010 [paperback])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- Checklist Supplement and Illustrative Financial Statements *Investment Companies* (product no. 0089410 [paperback] or WIS-CL [online])
- *Accounting Trends & Techniques, 63rd Edition* (product no. 0099009 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099109 [paperback] or WIF-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])
- Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools* (product no. 006639 [paperback] or WFM-XX [online])
- Audit and Accounting Practice Aid *Independence Compliance: Checklists and Tools for Complying With AICPA, SEC, and PCAOB Independence Requirements* (product no. 006660 [paperback] or WSC-XX [online])
- Financial Reporting Alert *Current Economic Crisis: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])

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.320 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification™*, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the

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.321 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's AnnualAccounting and Auditing Update Workshop(2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.
- *IFRS Essentials with GAAP Comparison: Building a Strong Foundation* (product no. 741602 [text], 181601 [DVD/Manual], or 351601 [Additional Manual for DVD]). This course provides you with a greater understanding of what you need to know as the acceptance of international standards continues to grow.

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.326 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at (877) 242-7212 or online at www.aicpa.org/Research/

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TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.327 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

The Center for Audit Quality

.328 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.329 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit www.aicpa.org/InterestAreas/CenterForAuditQuality/Pages/CAQ.aspx.

AICPA Industry Expert Panel—Investment Companies

.330 For information about the activities of the AICPA Investment Companies Expert Panel, visit the panel's website at www.aicpa.org/interestareas/accountingandauditing/community/investmentcompanies/Pages/InvestmentCompanies.aspx.

Industry Websites

.331 The Internet covers a vast amount of information that may be valuable to auditors of investment companies, including current industry trends and developments. Some of the more relevant sites for auditors with investment companies as clients include those shown in the following table:

Organization	*Website*
Commodity Futures Trading Commission	www.cftc.gov/
Financial Industry Regulatory Authority	www.finra.org/index.htm
Independent Directors Council	www.idc1.org
Investment Company Institute	www.ici.org/
Mutual Fund Directors Forum	www.mfdf.com/
Securities and Exchange Commission	www.sec.gov/

.332 The investment company practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs	www.pcfr.org

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Website Name	*Content*	*Website*
	of private companies and their constituents of financial reporting	
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Securities and Exchange Commission (SEC)	Information on current SEC rulemaking and the Electronic Data Gathering, Analysis, and Retrieval database	www.sec.gov
SEC Division of Investment Management	Contains links to, among other things, responses to frequently asked questions on a number of topics, recent no-action and interpretive letters, and a bibliography of valuation guidance for registered investment companies	www.sec.gov/divisions/investment.shtml

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AAM Section 8120

Not-for-Profit Entities Industry Developments—2011

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Not-for-Profit Entities Industry Developments—2010.*

This Audit Risk Alert is intended to provide auditors of financial statements of not-for-profit entities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

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Feedback

The Audit Risk Alert *Not-for-Profit Entities Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits of not-for-profit entities (NFPs) and also can be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may result in the material misstatement of financial statements and delivers information about emerging practice issues and current accounting, auditing, and regulatory developments. You should refer to the full text of accounting and auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert. Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11*(product no. 0223310) explains important issues that affect all entities in all industries in the current economic climate.

.02 It is essential that the auditor understand the meaning of audit risk and the interaction of audit risk with the objective of obtaining sufficient appropriate audit evidence. In AU section 312, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*), *audit risk* is broadly defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. Further, paragraph .04 of AU section 314, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*), explains that the auditor should use professional judgment to determine the extent of the understanding required of the entity and its environment. The auditor's primary consideration is whether the understanding that has been obtained is sufficient to assess risks of material misstatement of the financial statements and to design and perform further audit procedures.

Economic and Industry Developments

The Current Economy

.03 When planning and performing audit engagements, an auditor should understand both the general economic conditions and the specific economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, availability of credit, consumer confidence, overall economic expansion or contraction, inflation, real estate values, and labor market conditions are likely to have an effect on an entity's business and, therefore, its financial statements.

Key General Economic Indicators

.04 The following key economic indicators further illustrate the severity of the recent recessionary period experienced by the United States.

.05 The gross domestic product (GDP) measures output of goods and services by labor and property within the United States. It increases as the economy grows or decreases as it slows. According to the Bureau of Economic Analysis, real GDP increased at an annual rate of 1.7 percent in the second quarter of 2010 (third estimate), 3.7 percent in the first quarter of 2010, and 5.6 percent in the fourth quarter of 2009. From September 2009 to September 2010, the unemployment rate fluctuated between 9.5 percent and 10.1 percent. The annual average rate of unemployment increased from 4.6 percent in 2007 to 9.3 percent in 2009. An unemployment rate of 10.0 percent represents approximately 15.3 million people. Additionally, one reason for the continued high unemployment rate is that more Americans are resuming their search for work.

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.06 The Federal Reserve decreased the target for the federal funds rate more than 5.0 percentage points, prior to the financial crisis, to less than 0.25 percent, where it remained through October 2010. The Federal Reserve described the current economic recovery in its September 21, 2010, press release as follows:

- Household spending is increasing gradually but remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.
- Business spending on equipment and software is rising, though less rapidly than earlier in the year, and investment in nonresidential structures continues to be weak.
- Employers remain reluctant to add to payrolls.
- Housing starts are at a depressed level.
- Bank lending has continued to contract, but at a reduced rate in recent months.
- The pace of economic recovery is likely to be modest in the near term.

.07 The Federal Reserve also noted in the press release that "economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The Federal Reserve will keep constant its holdings of securities by reinvesting principal payments from mortgage-backed securities in longer-term Treasury securities; additionally, as current holdings of Treasury securities mature, the proceeds will be reinvested in Treasury securities. Since the beginning of the financial market turmoil in August 2007, total assets on the Federal Reserve's balance sheet have grown from $869 billion to $2.3 trillion. Further, the Federal Reserve will continue to monitor the economy and employ other policy tools as necessary.

The State of NFPs

.08 The NFP sector continues to play a large role in the world economy. Currently, 1.5 million NFPs are registered with the IRS. Contributions to these entities in 2009 exceeded $308 billion, whereas total revenues in the sector approached $2 trillion, and assets topped $4.2 trillion, as of October 2009. According to U.S. Department of Labor (DOL) statistics, 26.8 percent of the population, or 63.4 million people in the United States, did volunteer work for NFPs during 2009.

.09 Although contributions to NFPs are flat, demand for the services they provide is increasing. The value of endowments, which some entities rely on for support, may have decreased substantially (in some cases, to a point below historic cost), thereby reducing or eliminating much needed funding. As a result, some NFPs have been forced to reduce their workforce or cut back programs and services. Of particular concern is a lack of availability of affordable lines of credit; increased competition for a smaller pool of contributions; maintaining effective internal controls with a reduced staff; and an increase in the number of delayed or uncollectible pledges, grants, or accounts receivable.

Governance and Accountability

.10 Governance, accountability, and transparency continue to be areas of interest and refinement for NFPs. The National Association of Corporate Directors published its 2009 nonprofit governance survey, which represented the responses of more than 100 NFP board trustees regarding their board practices. According to the survey, board leadership was the number one concern for 63.8 percent of respondents. Other areas of continued focus were board evaluation, CEO succession planning, and IT risk. Trustees also reported that they have spent more time over the past 2 years reviewing the programmatic disclosures provided on IRS Form 990.

Corporate Sponsors

.11 According to a 2009 study released by the Committee Encouraging Corporate Philanthropy, 60 percent of companies cut their philanthropic donations in 2009, some by as much as 10 percent. However, in-kind giving continues to increase. More than one-third of corporate giving is in-kind. In some circumstances,

resources received from corporations are advertising or sponsorship arrangements rather than straightforward monetary contributions, and often, strings are attached to the transfer. Specifically, the corporation may require goods or services in exchange for those funds such as naming rights, discounted access to services, and advertisement of the company, among others. Because these transactions may be considered exchange transactions, contributions, or both, NFPs must be sure that the transactions are properly recorded in their books.

Funding Administrative Costs

.12 Foundations, corporations, and individuals may have different priorities when it comes to selecting an NFP to support. Some may consider the entity's mission, its reputation, the number of people served, or even who else supports it. One factor that frequently receives significant consideration is the percentage of each dollar that is spent on programs. Many donors have the perception that the biggest impact they can make with their contribution is by supporting only programmatic activities. Accordingly, operating expenses, such as the accounting department, maintenance and utilities, and the executive management staff, often must be supported by unrestricted dollars. Some entities follow policies for cost allocations, charges, assessments, or assignments that result in some amount of program-restricted contributions being used for operating expenses. Entities and their auditors should be careful to understand the administrative allocation process and whether paying for overhead costs with restricted contributions complies with donor stipulations. In addition, some NFPs are more frequently requesting funding for organizational administration either as a component of, or in addition to, their requests for program funding. Auditors should develop a full understanding of the terms of these agreements, including whether they result in restrictions on the use of the funds.

International Giving

.13 Worldwide relief efforts continue to arise for which American individuals, charities, and foundations are called upon to provide assistance and support. Auditors should be aware of the increased risks this provides for those organizations involved. The most notable concern is the use of donor funds in accordance with the donor's intended restriction (for example, Haiti relief). Auditors should be aware of the increased volume associated with international giving and the increased stress this can place on an organization's infrastructure to ensure the donations are processed properly and the usage of the funds is properly tracked. Additionally, for those chapters of national or international NFP organizations, the process of passing through the funds will present additional audit risks.

.14 Another risk that has arisen results from the ability of individual donors to text a predetermined code on their cell phones authorizing a donation amount (typically $5 or $10) to be added to their cell phone bills. This presents new challenges for the entities collecting these contributions and the NFPs that receive the funds relating to how these donations are tracked and how the revenue recognition process will take place.

.15 Additionally, for private foundations, auditors should be aware of the increased risk inherent in providing funding to recipient NFPs. NFPs need to implement and adhere to policies and procedures that will ensure accountability and tracking. Considerations for auditors are whether the revenue recognition process is complete and the transactions have been given the proper accounting treatment.

Retiring Work Force

.16 The demographic shift in the workplace, as baby boomers near retirement, is affecting the NFP sector. Surveys indicate that 50 percent to 70 percent of executive directors plan to leave within 5 years. Many are founders and leaders who are closely identified with their entities.

.17 Because the sector already suffers from fragile infrastructures, the transitions are expected to be hugely disruptive. Many NFPs devote resources to programmatic functions and do not have executives in training to replace these positions.

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.18 Auditors may want to consider how the retirement of a key employee, such as the executive director, will affect the NFP's internal control procedures, its ability to generate revenues and control expenses, and its ability to address these issues when they arise.

Cyber Donations

.19 The Internet has become the quick and easy means of providing and accessing information. It also has become a tool to expand the audience of NFPs in a way that appeals to younger and more technologically savvy donors. The Internet has thousands of websites for NFPs, and most of them provide an opportunity for a person to contribute. Many of these entities make use of services, such as PayPal, that permit donors to charge online donations to credit or debit cards. The money is then placed in an account similar to a bank account in the NFP's name, and a fee is deducted. At some future time, the money is then electronically transferred to another bank account, as specified by the NFP. This may be an area that auditors find worthy of attention because the NFP's internal controls that are required for these accounts may be different from those for deposit accounts at brick and mortar banks. For example, the entity may have controls regarding who is authorized to sign checks but may not have controls in place to safeguard usernames and passwords for accounts that allow transactions to be initiated through the Internet. One recent twist in both online and embedded giving is the advent of charity gift cards. The recipient of the gift card goes to the card's website and designates which of the listed charities is to receive the donations. Some sites charge an administrative fee at the time of purchase, but others charge the administrative fee when the card is redeemed.

Colleges and Universities—Contributions and Endowments

.20 According to a study conducted by the Council for Aid to Education, contributions to colleges and universities in the United States rose by just 0.54 percent for the 12-month period ending June 30, 2010, despite market recoveries. The Standard & Poor's 500 Index rose 12 percent during the same period.

.21 The 2010 NACUBO-Commonfund Study of Endowments, which gathered data from 850 colleges and universities, reported average returns on endowment investments of 11.9 percent (net of fees) for the 12-month period ending June 30, 2010. The average return for the same period in 2009 was -18.7 percent (net of fees). The report points out that the 3-, 5-, and 10-year return on endowments remain below the level colleges and universities needed for long-term funding after accounting for spending, inflations, and expenses. The report additionally indicates an increase in the average annual spending rate of colleges and universities with the largest endowments (greater than $500 million) to 5.6 percent in 2010 from 4.6 percent in 2009. Conversely, the average annual spending rate of endowments less than $25 million decreased to 3.5 percent.

Legislative and Regulatory Developments

Uniform Prudent Management of Institutional Funds Act

.22 In July 2006, the National Conference of Commissioners on Uniform State Laws (NCCUSL) approved the Uniform Prudent Management of Institutional Funds Act (UPMIFA) and recommended it for enactment by the legislatures of various states. UPMIFA is designed to replace the Uniform Management of Institutional Funds Act (UMIFA), which was approved by the NCCUSL in 1972. The purpose of UMIFA was to provide uniform and fundamental rules for the investment of funds held by charitable institutions and the expenditure of funds donated as endowments to those institutions. The principles behind those rules were as follows:

- Assets would be invested prudently in diversified investments that sought growth as well as income.
- Appreciation of assets could prudently be spent for the purposes of any endowment fund held by a charitable institution.

.23 In response to the increasing size and complexity of charitable endowments held in investments, UPMIFA was created based on the same principles. Since its creation, UPMIFA has been enacted in 47 states and the District of Columbia. As of March 2011, UPMIFA is pending legislation in Mississippi. Legislation has not been introduced in Pennsylvania and Florida.

Health Coverage Tax Credit for Exempt Organizations

.24 Effective for tax year 2010, many small businesses and tax-exempt organizations that provide health insurance coverage to their employees now qualify for a special tax credit. Included in the health care reform legislation, the Patient Protection and Affordable Care Act, approved by the United States Congress and signed by President Obama in March 2010, is a credit designed to encourage small employers to offer health care coverage for the first time or maintain the coverage they have.

.25 To be eligible for the credit, a qualifying employer must cover at least 50 percent of the cost of health care coverage for some of its workers, based on the rate for single person coverage. A qualifying employer also must have less than the equivalent of 25 full-time workers (for example, an employer with fewer than 50 half-time workers may be eligible) and must pay average annual wages below $50,000 per full-time equivalent (FTE) position.

.26 The credit is worth up to 35 percent of a small business's premium costs (25 percent for NFPs) in 2010. On January 1, 2014, this rate increases to 50 percent (35 percent for NFPs) but is subject to a phaseout. The credit phases out for entities with average wages between $25,000 and $50,000 and for entities with the equivalent of between 10 and 25 full-time workers.

IRS Guidance for NFPs

.27 Included in the frequently asked questions (FAQs) are some answers specifically for NFPs. They include information about the maximum credit that can be claimed by an NFP. For tax years 2010–13, the maximum credit for a tax-exempt qualified employer is 25 percent of the employer's premium expenses that count toward the credit in a qualifying arrangement, which are subject to a cap based on the average premium in each state. However, the amount of the credit cannot exceed the total amount of income and Medicare (that is, hospital insurance) tax the employer is required to withhold from employees' wages for the year and the employer share of Medicare tax on employees' wages.

.28 The FAQs provide the following example for the calculation of the credit for an NFP. For the 2010 tax year, a qualified NFP employer has 10 FTE employees with average annual wages of $21,000 per FTE position. The employer pays $80,000 in health care premiums for those employees (which does not exceed the average premium for the small group market in the employer's state) and otherwise meets the requirements for the credit. The total amount of the employer's income tax and Medicare tax withholding, plus the employer's share of the Medicare tax, equals $30,000 in 2010.

.29 The credit is calculated as follows:

1. Initial amount of credit determined before any reduction: $20,000 (0.25 x $80,000)
2. Employer's withholding and Medicare taxes: $30,000
3. Total 2010 tax credit: $20,000 (the lesser of $20,000 and $30,000)

.30 For a tax-exempt employer, the credit is a refundable credit, so even if the employer has no taxable income, the employer may receive a refund (so long as it does not exceed the income tax withholding and Medicare tax liability).

.31 For more information and to determine if an NFP qualifies for the Small Business Health Care Tax Credit, go to www.irs.gov.

Employment Tax Credits for Exempt Organizations

.32 Two tax benefits are now available to NFPs hiring workers who were previously unemployed or only working part time. These provisions are part of the Hiring Incentives to Restore Employment (HIRE) Act that was enacted into law in March 2010.

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.33 Employers who hire unemployed workers after February 3, 2010, and before January 1, 2011, may have qualified for a 6.2 percent payroll tax incentive, in effect exempting them from their share of Social Security taxes on wages paid to these workers after March 18, 2010. This reduced tax withholding will have no effect on the employee's future Social Security benefits, and employers would still need to withhold the employee's 6.2 percent share of Social Security taxes, as well as income taxes. The employer's and employee's share of Medicare taxes also would still apply to these wages.

.34 In addition, for each worker retained for at least 1 year, NFPs may claim an additional general business tax credit up to $1,000 per worker when they file their 2011 income tax returns.

.35 New hires filling existing positions also qualify but only if the workers they are replacing left voluntarily or for cause. Family members and other relatives do not qualify.

.36 In addition, the new law requires that the employer get a statement from each eligible new hire certifying that he or she was unemployed during the 60 days before beginning work or, alternatively, worked less than a total of 40 hours elsewhere during the 60-day period.

.37 Employers claim the payroll tax benefit on the federal employment tax return they file, usually quarterly, with the IRS. Eligible employers were able to claim the new tax incentive on their revised employment tax form for the second quarter of 2010. Revised forms and further details on these two new tax provisions are posted on www.irs.gov.

Commission to Report on Policies for Religious Organizations

.38 Evangelical Council for Financial Accountability (ECFA), a national accreditation organization for churches and other religious organizations, has been asked by U.S. Senate Finance Committee member Charles Grassley (R-IA) to lead an independent, national effort to review and provide input on major accountability and policy issues affecting such organizations. Grassley is known for his focus on the financial practices of high-profile nonprofit organizations.

.39 In response to Grassley's request, ECFA has created the Commission on Accountability and Policy for Religious Organizations. The commission will address some of the most challenging tax and policy issues involving religious organizations including

- whether churches should file the same highly detailed annual information return that other nonprofits must file (Form 990),
- whether legislation is needed to curb abuses of the clergy housing allowance exclusion,
- whether the current prohibition against political campaign intervention by churches and other nonprofits should be repealed or modified, and
- whether legislation is needed to clarify tax rules covering "love offerings" received by some clergy.

IRS Activities

IRS Exempt Organizations Division 2011 Work Plan

.40 This year, the Exempt Organizations Division (EO) of the IRS will support several overarching focus areas which are included in its 2011 Work Plan. These areas include, among others, the following:

- *Impact of recent legislation*. With the passage of several pieces of legislation, EO is working with the whole of IRS to implement effective changes and laws. Legislation that effects exempt organizations includes
    - — the Affordable Care Act (ACA), which was enacted on March 23, 2010. It contains certain tax provisions that take effect this year and more that will be implemented during the next several years. Several provisions, primarily those involving tax-exempt hospitals and

exempt organizations as employers, fall under the purview of EO. Each of the EO offices has a role in putting together a comprehensive program to implement the changes and fulfill ACA requirements.

- HIRE, which as previously mentioned was signed into law on March 18, 2010. The legislation identified tax-exempt organizations as employers eligible to claim the payroll tax exemption and new hire retention credit for eligible newly hired employees. Beginning in July 2010, the Exempt Organizations Compliance Area began conducting examinations of credits claimed under HIRE.
- the American Recovery and Reinvestment Act (Recovery Act), which established a 65 percent subsidy on Consolidated Omnibus Budget Reconciliation Act (COBRA) health insurance premiums to help workers who lost their jobs as a result of the recession maintain their employer-sponsored health insurance. The Continuing Extension Act of 2010, enacted April 15, reinstated the COBRA subsidy, which had expired on March 31.

- *International focus*. International tax enforcement is an ongoing priority for the IRS. Taxpayers with international activities, transactions, and accounts pose unique compliance issues for the IRS. EO's concern in this area is whether charitable assets of exempt organizations are being diverted internationally for noncharitable purposes. IRS efforts in this area include
  - foreign entities receiving IRS recognition of exemption from U.S. taxes;
  - information referred from the Joint International Tax Shelter Information Center;
  - charities reporting foreign addresses on Forms 990;
  - charities that participate in gifts-in-kind programs, because valuation issues surface when charities send noncash items to foreign organizations; and
  - large private foundations with international operations or international transactions.
- *National Research Program (NRP)—study of employment tax returns*. IRS estimates employment tax misreporting constitutes a large part of the tax gap—close to $54 billion per year. In light of this sizeable amount, the IRS has updated its understanding of compliance in this area and has implemented a comprehensive IRS–wide study to measure compliance, improve IRS ability to detect and reduce noncompliance, and ensure the fairness of the tax system. Specifically, the NRP project looks at employment tax on both taxable and tax-exempt organizations, large and small businesses, and the government sector.
- *Nonfiler initiatives*. The goals of the IRS nonfiler strategy are to
  - help taxpayers understand and meet their filing obligations,
  - improve voluntary compliance by reducing taxpayer burden,
  - leverage technology to identify nonfilers, and
  - effectively use enforcement resources to deter nonfilers.
- *Colleges and universities*. In 2008, the IRS sent 400 questionnaires to public and private 4-year colleges and universities asking about their unrelated business income, endowments, and executive compensation practices. The goal was to gain a better understanding of one of the largest, most complex segments in the NFP sector and identify issues and areas that may need more outreach and education or further scrutiny.
- *Form 990-N misfilers*. Since 2007, small tax-exempt organizations with annual gross receipts that are normally $25,000 or less may be required to electronically submit Form 990-N, also known as the e-Postcard, unless they choose to file a complete Form 990 or Form 990-EZ. The failure of an organization that is required to file a Form 990 series return for 3 consecutive years results in automatic revocation of the organization's exempt status. The objective of this project is to identify organizations that incorrectly file Form 990-N.

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- *Form 990 as a compliance tool*. The Form 990 is the IRS's primary tool to increase transparency and to promote and enforce compliance with federal tax law. As more organizations file the redesigned Form 990, EO examinations will use the updated form to identify noncompliant and potentially noncompliant organizations for examination to develop targeted compliance projects and to inform and supplement educational efforts.
- *Governance*. Starting in fiscal year 2010, EO began using a check sheet to capture governance practices and the related internal controls of the organizations being examined. EO will analyze the data over the long term to gain a better understanding of the intersection between governance practices and tax compliance.
- *Section 501(c)(4), (5), and (6) organizations*. In recent years, the examination program has concentrated on Section 501(c)(3) organizations. Beginning in fiscal year 2011, it is increasing its focus on section 501(c)(4), (5), and (6) organizations. With the additional information available on the new Form 990, the IRS will look at issues including political activity, inurement, and the extent of compliance with the requirements for tax exemption by organizations that self-identified as a section 501(c)(4), (5), or (6) organization.
- *Voluntary employees' beneficiary associations* (VEBAs). A *voluntary employees' beneficiary association* is defined under Internal Revenue Code (IRC) Section 501(c)(9) as an organization designed to pay life, sick, accident, and similar benefits to members, their dependents, or designated beneficiaries, as long as no part of the net earnings of the association inures to the benefit of any private shareholder or individual.

.41 Additional information on these and other topics, as well as the complete EO 2011 Work Plan, is available at www.irs.gov/charities.

Department of the Treasury and IRS Issue Priority Guidance Plan for 2010

.42 The joint Department of Treasury and IRS priority guidance plan for 2010–11 contains the following items of interest to tax-exempt organizations:

- Final regulations to implement Form 990 revisions and modify the public support test
- Guidance updating grantor and contributor reliance criteria under IRC sections 170 and 509
- Final regulations on new requirements for supporting organizations, as added by the Pension Protection Act of 2006
- Guidance on excess business holdings rules in IRC Section 4943, as amended by the Pension Protection Act
- Guidance on program-related investments under IRC Section 4944
- Regulations on new excise taxes on donor-advised funds and fund management under IRC Section 4966, as added by the Pension Protection Act
- Regulations on group returns
- Regulations to update final regulations under IRC Section 6104(c) relating to disclosure to state charity agencies
- Final regulations under IRC Section 6104 regarding disclosure of certain administrative actions that are required to be made available to the public
- Regulations under IRC Section 512 explaining how to compute unrelated business taxable income of VEBAs described in IRC Section 501(c)(9)
- Regulations under IRC Section 6611 regarding interest on overpayments by tax-exempt organizations

.43 Additional information on these and other topics is available at www.irs.gov/charities/article/0,,id=215962,00.html.

Listing of Published Guidance—2011

.44 Readers should be aware that the IRS website contains a digest of published guidance for tax-exempt entities issued in 2011 at www.irs.gov/charities/content/0,,id= 232774,00.html. The published guidance includes treasury regulations, revenue rulings, revenue procedures and notices, and announcements of recently published issues of interest to tax-exempt entities.

.45 The IRS website also contains an archive that presents digests of IRS–published guidance of interest to tax-exempt entities for the years 1954–2010. The archived guidance can be found at www.irs.gov/charities/article/0,,id=151053,00.html. Additionally, the IRS has a useful tool for NFPs to assist them in maintaining their tax-exempt status through compliance with IRS requirements. The publication *Compliance Guide for 501(c)(3) Public Charities* is available at www.irs.gov/pub/irs-pdf/p4221pc.pdf.

Audit Considerations of the American Recovery and Reinvestment Act of 2009

.46 One challenge for auditors performing single audits of entities with the Recovery Act funds continues to be keeping up with and understanding the various sources of requirements and guidance that are being issued on an ongoing basis. In addition to the Recovery Act itself, auditors need to be familiar with the implementation and audit guidance that has been issued by the federal government, as well as what will be issued in the future. The guidance issued is targeted at various stakeholders (for example, federal awarding agencies, award recipients, and auditors), and in many cases, one piece of issued guidance will affect more than one of these stakeholders. Since March 2010, the following memorandums have been issued by the Office of Management and Budget (OMB):

- M-10-34, *Updated Guidance on the American Recovery and Reinvestment Act* (September 24, 2010)
- M-10-17, *Holding Recipients Accountable for Reporting Compliance under the American Recovery and Reinvestment Act* (May 4, 2010)
- M-10-14, *Updated Guidance on the American Recovery and Reinvestment Act* (March 22, 2010)

.47 In addition to the more recently issued memorandums previously listed, several other pieces of OMB guidance are of particular continuing interest to auditors. They include the following:

- M-10-08, *Updated Guidance on the American Recovery and Reinvestment Act—Data Quality, Non-Reporting Recipients, and Reporting of Job Estimates* (December 18, 2009)
- M-10-05, *Improving Compliance in Recovery Act Recipient Reporting* (November 30, 2009)
- M-10-03, *Payments to State Grantees for their Administrative Costs for Recovery Act Funding—Alternative Allocation Methodologies* (October 13, 2009)
- M-09-30, *Improving Recovery Act Recipient Reporting* (September 11, 2009)
- M-09-15, *Updated Implementing Guidance for the American Recovery and Reinvestment Act of 2009* (issued April 3, 2009)
- M-09-10, *Initial Implementing Guidancefor the American Recovery and Reinvestment Act of 2009* (issued February 18, 2009)
- FAQs (updated regularly to address FAQs related to the OMB memorandums issued to date)

.48 The other key mechanism that the OMB is using to notify auditors of entities with expenditures of Recovery Act funds of additional compliance requirements and auditor guidance is the compliance supplement and any subsequently issued addendums to the compliance supplement. Because additional guidance will be issued by the federal government on an ongoing basis, auditors should watch the OMB website at www.whitehouse.gov/omb/recovery_default.

.49 The AICPA Government Audit Quality Center (GAQC) has established the GAQC Recovery Act Resource Center to provide members with a one-stop repository location with information related to the

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Recovery Act that may be of interest to auditors. For more information, go to the GAQC website www.aicpa.org/interestareas/governmentalauditquality/resources/recoveryactresourcecenter/Pages/default.aspx.

Filing and Audit Requirements for Employee Retirement Income Security Act–Covered Section 403(b) Employee Benefit Plans

.50 In July 2007, the IRS issued the first comprehensive regulations for 403(b) plans, bringing 403(b) plans closer to the standards set for 401(k) plans. The new IRS regulations clarified several points on employer responsibility and required organizations to have a written plan in place. The new rules were effective on or after January 1, 2009, with certain exceptions.

.51 In addition to the IRS regulations, the DOL issued amended regulations to make 403(b) plans covered by the Employee Retirement Income Security Act (ERISA) subject to the same Form 5500 reporting and audit requirements as 401(k) plans effective with their 2009 Form 5500 filings. However, 403(b) plans that meet all of the following conditions are exempt from the following ERISA audit requirements:

- There are no employer contributions.
- The plan includes only employee voluntary contributions.
- The employer has limited involvement in the plan.
- No compensation is paid to the employer in connection with the plan.
- Rights under the plan are enforceable solely by the participants and their beneficiaries against the provider and not against the employer.

Additional DOL Guidance Related to 403(b) Plans

.52 On July 20, 2009, the DOL issued Field Assistance Bulletin (FAB) No. 2009-02, *Annual Reporting Requirements for 403(b) Plans*. DOL FAB No. 2009-02 allows a plan administrator of a 403(b) plan to exclude certain contracts and accounts from plan assets for purposes of ERISA's annual reporting requirements under certain specified conditions.

.53 If the plan administrator elects to exclude some or all of those contracts or accounts meeting the conditions of DOL FAB No. 2009-02 from the plan's financial statements or instructs the auditor not to perform procedures on certain or all pre-2009 contracts, or both, the plan's auditor will need to consider the effect of the exclusions on the completeness of the financial statement presentation and restrictions on the scope of the audit. The plan auditor may be faced with both a departure from generally accepted accounting principles in the United States (U.S. GAAP) and a scope limitation on the audit. In many cases, this could result in the auditor issuing a qualified, adverse, or disclaimer of opinion.

.54 In February 2010, the DOL issued FAB No. 2010-01, *Annual Reporting and ERISA Coverage for 403(b) Plans*, which supplements DOL FAB No. 2009-02 and addresses questions the DOL received concerning the scope of FAB No. 2009-02 and the safe harbor regulations at Title 29 U.S. *Code of Federal Regulations* Part 2510.3-2(f). DOL FAB No. 2010-01 addresses, among other things, the plan administrator's responsibility to determine whether the conditions of DOL FAB No. 2009-02 have been satisfied with respect to excluded contracts from the plan's annual report.

.55 The full texts of DOL FAB No. 2009-02 and DOL FAB No. 2010-01 are available at www.dol.gov/ebsa/regs/fab2009-2.html and www.dol.gov/ebsa/regs/fab2010-1.html, respectively.

Considerations of Modified Opinions in Relation to 403(b) Plan Audits

.56 Auditors of NFPs that have 403(b) plans may encounter circumstances when the plan's auditor issued a modified opinion. When the financial statements for the prior period included a modification to the auditor's opinion, for example, if the auditor was not able to complete audit procedures relating to completeness and accuracy of the beginning balance of participant accounts because the plan administrator was not able to

provide sufficient data due to the lack of historical plan-level records, the plan's auditor should determine whether changes have occurred that may affect the relevance of such information in the current year audit of the 403(b) plan audit. If the matter giving rise to the modification remains relevant and material to the current period's financial statements, the auditor may determine it is necessary to modify the opinion on the current period's financial statements. In some situations, a modification to the prior period's opinion may not be relevant and material to the opinion on the current period's financial statements. This may be the case when, for example, there was a scope limitation in the prior period, but the matter giving rise to that limitation has been resolved in the current period.

.57 Additional information is available through the AICPA Employee Benefit Plan Audit Quality Center at www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Pages/EBPAQhomepage.aspx.

Impact of Red Flags Rule on Colleges and Universities

.58 In October 2007, the Federal Trade Commission (FTC) issued the Red Flags Rule for financial institutions and creditors to fight identity theft. The rule sets out how certain businesses and organizations must develop, implement, and administer their identity theft prevention programs. Creditors subject to the Red Flags Rule must be in compliance as of January 1, 2011. There has been considerable discussion and debate amongst the higher education community about whether the Red Flags Rule applies to colleges and universities or if the Red Flag Program Clarification Act of 2010 passed by Congress in December 2010 exempted them. The answer, as is typical in such cases, is maybe.

.59 The changes made to the law were meant to provide relief to small businesses such as doctor's offices, CPAs, and small retailers. It is important to note that neither the law nor the FTC regulations specifically identifies covered entities. Rather, the determination is made based on the activities that the organization engages in as part of its business. Under the new definition, an entity is considered a *creditor* if it meets any one or more of the following conditions:

- It obtains or uses credit reports, directly or indirectly, in connection with a credit transaction.
- It furnishes information to consumer reporting agencies in connection with a credit transaction.
- It advances funds to or on behalf of a person, based on an obligation of the person to repay the funds or repayable from specific property pledged by or on behalf of the person.

.60 Based on this definition, any institution that provides loans to students or processes loan applications could be considered a creditor and would be subject to the rule. Additionally, if tuition is billed after a student has attended classes (not the typical model for higher education), then the institution could be considered to be a creditor.

.61 Any occurrence of identity theft exposes a creditor to an FTC investigation. Based on the results of the investigation, the FTC can seek both monetary civil penalties and injunctive relief. In addition, it is likely that enforcement actions will be widely publicized, which could result in significant damage to the reputation of the institution.

.62 From an audit perspective, compliance with the Red Flags Rule and the robustness of the institution's formal identity theft prevention program will likely be considered in the overall risk assessment of the organization. Colleges and universities should provide a copy of the program to their auditors as part of their documentation of internal controls.

.63 More information and a document outlining specific requirements of the Red Flags Rule can be found at http://ftc.gov/redflagsrule.

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Audit and Attestation Issues and Developments

Audit Risks for NFPs

.64 As noted in paragraph .17 of AU section 312, some possible audit responses to significant risks of material misstatement include increasing the extent of audit procedures, performing procedures closer to year-end, or modifying audit procedures to obtain more persuasive evidence. Additionally, given the constantly changing status of economic conditions that could affect your NFP client, auditors may consider changes in the environment throughout the audit and potentially modify audit procedures to ensure that risks are adequately addressed.

.65 Although it is impossible to predict and include all accounting, auditing, and attestation issues that may affect your NFP engagements, we cover in this alert the primary areas of concern. Continue to remain alert to economic, legislative, and regulatory developments, as well as the associated accounting, auditing, and attestation issues, as you perform your engagements.

Supplementary and Other Information Related to Financial Statements

.66 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information (RSI). These three standards supersede AU sections 550A, *Other Information in Documents Containing Audited Financial Statements*; 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.67 Statement on Auditing Standards (SAS) No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility relative to other information in documents containing audited financial statements and the auditor's report thereon. Typically for an NFP organization, this includes the client's annual report and those reports issued to governmental agencies. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information.

Supplementary Information in Relation to the Financial Statements as a Whole

.68 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For NFPs, this typically includes consolidating schedules and those that may have an organizational purpose but excludes RSI that is considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. An example of supplementary information that would be included under SAS No. 119 would be the Schedule of Expenditures of Federal Awards in the financial statements of an NFP that falls under OMB Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations*. Such information may be presented in a document containing the audited financial statements or separate from the financial statements.

Required Supplementary Information

.69 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558), addresses the auditor's responsibility with respect to RSI. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. For an NFP, this would include the information that a designated accounting standard setter

considers to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. SAS No. 120 requires the auditor to perform specified procedures in order to

- describe, in the auditor's report, whether RSI is presented and
- communicate therein when some or all of the RSI has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the RSI for it to be in accordance with guidelines established by the designated accounting standard setter.

Compliance Audits

.70 SAS No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801), is applicable for compliance audits when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following:

- Generally accepted auditing standards (GAAS)
- The standards for financial audits under *Government Auditing Standards*
- A governmental audit requirement that requires an auditor to express an opinion on compliance (for example, a compliance audit performed under OMB Circular A-133)

.71 Compliance audits are usually performed in conjunction with a financial statement audit (an example is the financial statement audit performed under *Government Auditing Standards* as part of a single audit). However, note that paragraph .02 of SAS No. 117 states that the guidance in SAS No. 117 does not apply to the financial statement audit component of the engagement. Also, SAS No. 117 is not applicable when a governmental audit requirement calls for an examination of an entity's compliance with specified requirements or an examination of an entity's internal control over compliance in accordance with Statements on Standards for Attestation Engagements (SSAEs). In this case, AT section 601, *Compliance Attestation* (AICPA, *Professional Standards*), is applicable to the engagement.

.72 SAS No. 117 states that a compliance audit is based on the premise that management is responsible for the entity's compliance with compliance requirements. This responsibility includes the following:

- Identifying the entity's government programs and understanding and complying with the compliance requirements
- Establishing and maintaining effective internal controls that provide reasonable assurance that the entity administers the government programs in compliance with the compliance requirements
- Evaluating and monitoring the entity's compliance with the compliance requirements
- Taking corrective action when instances of noncompliance are identified, including corrective action on audit findings of the compliance audit

.73 The auditor's objectives in the compliance audit portion of a single audit are to

- obtain sufficient appropriate audit evidence to form an opinion and report at the level specified in the governmental audit requirement (for example, OMB Circular A-133 in a single audit) on whether the entity complied in all material respects with the applicable compliance requirements. Note that SAS No.117 defines *applicable compliance requirements* as the compliance requirements that are subject to the compliance audit, which in the case of a single audit, are the direct and material types of compliance requirements.
- identify audit and reporting requirements specified in the governmental audit requirement (for example, OMB Circular A-133) that are supplemental to GAAS and *Government Auditing Standards* and perform procedures to address those requirements.

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.74 In addition to the guidance discussed in this section of the alert, SAS No. 117 contains other guidance, including the following topics:

- Performing risk assessment procedures
- Assessing the risks of material noncompliance
- Performing further audit procedures in response to assessed risks
- Written representations
- Subsequent events
- Evaluating the sufficiency and appropriateness of the audit evidence and forming an opinion
- Reporting
- Documentation

.75 When implementing the provisions of SAS No. 117 for a single audit, it is important to remember that *Government Auditing Standards* and OMB Circular A-133 (the governmental audit requirement) contain certain standards and requirements that are supplemental to those in GAAS and that will need to be addressed in the compliance audit. SAS No. 117 is effective for compliance audits for fiscal periods ending on or after June 15, 2010.

Auditing Alternative Investments

.76 The AICPA practice aid *Alternative Investments—Audit Considerations* is a useful tool for auditors that focuses on the existence and valuation assertions associated with alternative investments, but it also discusses general considerations pertaining to auditing alternative investments, management representations, disclosure of certain significant risks and uncertainties, and reporting. As defined in the foreword of the practice aid, *alternative investments* are

> investments for which a readily determinable fair value does not exist ... includ[ing] private investment funds meeting the definition of an *investment company* ... such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity funds, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds.

.77 You can access the full text of this practice aid on the AICPA's website at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Practice+Aids+and+Tools/alternative_investments.htm.

.78 The practice aid suggests that when the auditor determines the nature and extent of audit procedures, he or she should include verifying the existence of alternative investments. Confirming investments in aggregate does not constitute adequate audit evidence with respect to the existence assertion. Confirmation of existence of the holdings of the alternative investments on a security-by-security basis may constitute adequate audit evidence. Even if the fund manager confirms all requested information, the auditor may, based on his or her assessment of the risks of material misstatement, perform additional procedures, such as the following:

- Observe management site visits or telephone calls to investee funds (or reviewing documentation of such calls or visits)
- Review executed partnership, trust, limited liability corporation, or similar agreements
- Inspect other documentation supporting the investor's interest in the fund (for example, correspondence from the fund or trustee acknowledging transactions with the fund)
- Review periodic statements from the fund reflecting investment activity and comparing activity with amounts reported by the investor
- Vouch relevant cash receipts and disbursements

.79 Using one or more of the preceding approaches or another audit procedure in order to gather sufficient appropriate audit evidence with respect to the existence assertion requires considerable auditor judgment.

.80 During challenging economic times, investment funds may impose limitations on redemptions and some even unwind. As this occurs, the fair value measurements applied to these investments will become even more challenging. In September 2009, Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-12, *Fair Value Measurements and Disclosures (Topic 820): Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent)*, which discusses fair value measurement of alternative investments. For more details, see the section titled "Fair Value" in this alert or the ASU on FASB's website at www.fasb.org.

Auditing Fair Value Measurements

.81 In addition to understanding the looming questions relative to accounting for fair value measurements, auditors should be aware of audit issues involving fair value measurements. Particular assets, liabilities, and components of net assets are measured or disclosed at fair value in the financial statements, and it is management's responsibility to make the fair value measurements and disclosures. This includes alternative investments, gifts in kind, and defined-benefit pension plan assets and liabilities, as well as investments in split-interest agreements. When auditing these fair values to ensure they are in conformity with U.S. GAAP, auditors should consult AU section 328, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards*), which establishes standards and provides guidance for auditors.

.82 In regard to analyzing the sufficiency of the audit evidence, the strongest audit evidence to support a fair value is an observable price in an active market (level 1). If that is not available, a valuation method should incorporate market-based assumptions that market participants would use in their estimates when that information is available without undue cost and effort. If information about market participant assumptions is not available, management may use its own assumptions as long as there are no contrary data indicating that market participants would use different assumptions (level 3).

.83 The auditor should obtain an understanding of the entity's process for determining fair values, as well as whether the fair value measurements and disclosures are in accordance with U.S. GAAP. When obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the auditor considers, for example

- controls over the process used to determine fair value measurements.
- the expertise and experience of those persons determining the fair value measurements.
- the extent to which management's process relies on a service organization to provide fair value measurements or the data that supports the measurements.
- the process used to develop and apply management assumptions, including whether management used available market information to develop the assumptions.
- the significant management assumptions used in determining fair values.

.84 According to paragraph .23 of AU section 328, substantive tests of the fair value measurements may involve (*a*) testing management's significant assumptions, the valuation model, and the underlying data; (*b*) developing independent fair value estimates for corroborative purposes; or (*c*) reviewing subsequent events and transactions. Paragraph .26 also notes that when testing the fair value measurements and disclosures, the auditor should evaluate whether management's assumptions are reasonable and reflect, or are not inconsistent with, market information. According to FASB *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures,* this may include evaluating

- whether a significant decrease has occurred in the volume and level of activity for the asset or liability when compared with normal market activity, which may include consideration of the number of recent transactions, the date of the most recent price quotes, consistency among price quotes, increases in implied liquidity risk premiums, increases in the bid-ask spread, and the amount of publicly available information.

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- whether the transaction was an orderly transaction, which may include consideration of the seller's financial condition, the counterparty credit position, the exposure to the market during the marketing period, and the actual transaction price.
- the reasonableness of the underlying assumptions, which may include consideration of the use of pricing services, the assumptions used by the pricing service, and the extent of testing required to verify the reasonableness of the prices provided. (For example, the auditor should understand whether the fair value measurement was determined using quoted prices from an active market, observable inputs, or fair value measurements based on a model. If the price is not based on quoted prices from an active market or observable inputs, the auditor should obtain an understanding of the model used by the pricing service and evaluate whether the assumptions are reasonable [see the following section for additional information on pricing services].)
- the reasonableness of the determination within the fair value hierarchy of inputs.

Fair Values of Securities

.85 The guidance in AU section 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*), relating to auditing the fair value of securities is fairly similar to the guidance in AU section 328; however, there are some items of note for the auditor. As previously mentioned, quoted market prices in active markets are the best available audit evidence to support fair values; however, when quoted market prices are unavailable and the valuations of securities are obtained from a broker-dealer or another pricing service, the auditor should understand the method used by the broker-dealer or pricing service to estimate the fair value measurement (such as a pricing model, a cash flow projection, or other method). These fair value estimates also may be based on quoted prices from an active market for similar securities or other observable inputs or may be based on valuation models that will be a consideration on the auditor's procedures. The auditor should evaluate the methods and assumptions used by the pricing service to estimate fair value to determine whether those methods and assumptions are consistent with the requirements of GAAP (as discussed in FASB ASC 820-10-35). The auditor also may determine that it is necessary to obtain quotes from more than one pricing source based on circumstances, such as an existing relationship between the entity and the pricing source, which could inhibit objective pricing, and underlying significant valuation assumptions that are highly subjective. In the context of FASB ASC 820, quoted prices in active markets are considered level 1 inputs.

.86 Substantive testing procedures on management's assertions about fair value determined by a model may include the following:

- Assessing the reasonableness and appropriateness of the model
- Assessing the reasonableness and appropriateness of the assumptions used
- Comparing management's assumptions with observable data, such as industry reports or benchmarks
- Calculating the value using a model developed by the auditor or a specialist engaged by the auditor to determine an independent expectation to corroborate the reasonableness of the value calculated by the entity
- Comparing the fair value with subsequent or recent transactions

.87 Whether the inputs to the entity's valuation model are observable determines their characterization as level 2 or level 3 inputs, respectively, within FASB ASC 820-10-35. When extensive judgment is needed, consider using a specialist or refer to AU sections 328 and 342, *Auditing Accounting Estimates* (AICPA, *Professional Standards*). Additionally, when the underlying collateral of a security significantly contributes to its fair value and collectability, evidence of the collateral also should be examined for existence, fair value, transferability, and the investor's right to the collateral.

.88 Paragraph .19 of AU section 328 also notes that the auditor should evaluate whether the entity's method for determining fair value measurements is applied consistently and, if so, whether the consistency is

appropriate considering possible changes in the environment or circumstances affecting the entity or changes in accounting principles.

.89 The auditor also should evaluate management's conclusions regarding other-than-temporary impairment (OTTI) on its equity and debt securities. Factors that could cause OTTI for equity securities are included in paragraph .47 of AU section 332.

.90 Auditors should consider all facts and circumstances when determining if OTTI has occurred for an equity security.

Auditing Accounting Estimates

.91 As noted in paragraph .04 of AU section 342, the auditor is responsible for evaluating the reasonableness of accounting estimates made by management in the context of the financial statements as a whole. Although this alert has discussed fair value measurements at length, it is important to remember many types of accounting estimates exist in NFP client financial statements. Some examples include the allowance for uncollectible accounts and pledges receivable, impairment analysis and estimated useful lives of long lived assets, and actuarial assumptions in pension and other postretirement benefit costs.

.92 As discussed in paragraph .09 of AU section 342, key factors and assumptions on which the auditor normally concentrates include the assumptions that are significant to the estimate, sensitive to variations, deviations from historical patterns, or particularly subjective and susceptible to misstatement and bias; however, it is important to consider whether historical patterns are still applicable.

Service Organizations

.93 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324), has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attest standard and an auditing standard to better reflect the nature of the work being performed. SSAE No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), contains the requirements for reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, and earlier implementation is permitted. A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization,* will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. Until the new SAS is effective, user auditors will still use the guidance currently contained in AU section 324.

.94 The AICPA is in the process of overhauling and rewriting the Audit Guide *Service Organizations: Applying SAS No. 70, as Amended*(commonly known as the SAS 70 guide). Also, to address reporting on a service provider's controls over subject matter other than financial reporting, the AICPA is developing a new Audit Guide, *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*. Both guides are expected to be available for sale in spring of 2011. The AICPA is also in the process of drafting communication materials that will help auditors, clients, and users understand the three types of service organization control (SOC) reports (formerly SAS No. 70 reports) to be used for reporting on these engagements.

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	Title	*Description*
SOC 1	*Service Organizations—Applying SSAE No. 16,* Reporting on Controls at a Service Organization *(SOC 1)*	To be used only in circumstances when the service organization's services and controls affect the internal control over financial reporting for the entities that use the service.
SOC 2	*Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*	The purpose is to convey trust and assurance to users of the system that the service organization has deployed an effective control system to effectively mitigate operational and compliance risks that the system may represent to its users.
SOC 3	*Trust Services Report*	These reports are designed to meet the needs of users who want assurance on the controls at a service organization related to security, availability, processing integrity, confidentiality, or privacy of a system but do not have the need for the level of detail provided in an SOC 2 report. These reports are general use reports and can be freely distributed or posted on a website as a seal.

Compilation and Review Engagements

.95 The AICPA Guide *Compilation and Review Engagements* provides additional information on implementing Statement on Standards for Accounting and Review Services No. 19, *Framework for Performing and Reporting on Compilation and Review Engagements* (AICPA, *Professional Standards*). It also includes illustrative engagement and representation letters, sample compilation and review reports, detailed illustrations, and case studies. This guide is now available electronically and in paperback on www.cpa2biz.com.

Accounting Issues and Developments

.96 Given the current economic climate, auditors should consider a number of accounting and financial reporting issues, such as the following:

- Mergers and acquisitions
- Disclosures of open tax years
- Reporting guarantees
- Reporting costs paid for affiliates
- Fair value and related disclosures
- Valuing gifts in kind

NFP Mergers and Acquisitions

.97 In April 2009, FASB issued FASB Statement No. 164, *Not-for-Profit Entities: Mergers and Acquisitions—Including an amendment of FASB Statement No. 142*. This statement is effective for mergers occurring on or after December 15, 2009, and acquisitions for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2009.

.98 The purpose of this statement is to improve the relevance, representational faithfulness, and comparability of the information that an NFP provides in its financial reports about a combination with one or more NFPs, businesses, or nonprofit activities. To accomplish that, this statement establishes principles and requirements for how an NFP

- determines whether a combination is a merger or an acquisition.

- applies the carryover method in accounting for a merger which requires combining the historical cost of assets and liabilities recognized in the separate financial statements of the merging entities as of the merger date (or that would be recognized if the entities issued financial statements as of that date).
- applies the acquisition method in accounting for an acquisition, including determining which of the combining entities is the acquirer. The acquisition method includes recognizing the fair value of identifiable assets acquired and liabilities assumed. It also requires recognizing goodwill acquired or a contribution received if applicable.
- determines what information to disclose to enable users of financial statements to evaluate the nature and financial effects of a merger or an acquisition.

.99 It also is intended to improve the information an NFP provides about goodwill and other intangible assets after an acquisition by amending FASB Statement No. 142, *Goodwill and Other Intangible Assets*, to make it fully applicable to NFPs.

.100 The carryover method is similar to, but not exactly the same, as the old pooling-of-interest method of accounting for mergers. An important difference is that under the carryover method, the first reporting period for the new merged entity starts as of the merger date. The merger date may be a date later than the start of the newly merged entity's fiscal year and, as a result the first financial reporting period for the merged entity, might be less than 12 months.

.101 Under the acquisition method, identifiable assets include intangible assets. Intangibles are assets that lack physical substance such as patents, trademarks, contract rights, and software. The term *intangible asset* is used to refer to intangible assets other than goodwill. Goodwill is measured as the residual of the excess of the consideration transferred at the acquisition date over the fair values of the identifiable net assets acquired.

.102 Should the acquisition contain a bargain purchase (that is, a business combination in which the total fair value of the identifiable net assets acquired, at the acquisition date, exceeds the fair value of the consideration transferred), the acquirer will recognize that excess of fair value received as a contribution in the statement of activities.

.103 Goodwill shall not be amortized. Goodwill shall be tested for impairment at a level of reporting referred to as a reporting unit. Impairment is the condition that exists when the carrying amount of goodwill exceeds its implied fair value.

.104 In January 2010, FASB issued ASU No. 2010-07, *Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*, which codifies FASB Statement No. 164 primarily in FASB ASC 958-805 and 958-810. Readers are encouraged to review the full texts of FASB Statement No. 164 and ASU No. 2010-07, which are available on FASB's website.

Accounting for Uncertainty in Income Taxes

.105 For many calendar year nonpublic entities, 2009 was the first year of application of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (codified in FASB ASC 740, *Income Taxes*), and related guidance. Although many NFPs may not have determined that it was necessary to record a material liability for uncertain tax positions, all NFPs are required to include certain disclosures in their financial statements. In 2010, the AICPA issued Technical Questions and Answers (TIS) section 5250.15, "Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions" (AICPA, *Technical Practice Aids*). TIS section 5250.15 reminds nonpublic entities of the disclosure requirements of FASB ASC 740-10, which includes the requirement to disclose a description of the tax years that remain subject to examination by major tax jurisdictions. FASB ASC 740-10-55-217 provides the following sample disclosure that would meet the requirement to disclose a description of the "open" tax years:

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> The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various states and foreign jurisdictions. With few exceptions, the Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 20X1.

.106 NFPs may find it necessary to consult with tax advisers to determine the appropriate tax years to disclose as subject to examination by major tax jurisdictions.

Correction of Net Assets Balances Reported in Prior Periods

.107 In some instances NFPs may be required to change net asset classifications that were reported in a previous year. In these circumstances, the NFP would determine whether the change is a result of a change in accounting principle or the result of the correction of an error.

.108 FASB ASC glossary defines *change in accounting principle* as

> A change from one generally accepted accounting principle to another generally accepted accounting principle when there are two or more generally accepted accounting principles that apply or when the accounting principle formerly used is no longer generally accepted. A change in the method of applying an accounting principle also is considered a change in accounting principle.

.109 FASB ASC glossary defines an *error in previously issued financial statements* as

> An error in recognition, measurement, presentation, or disclosure in financial statements resulting from mathematical mistakes, mistakes in application of generally accepted accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared. A change from an accounting principle that is not generally accepted to one that is generally accepted is a correction of an error.

.110 The guidance found in FASB ASC 250-10 states that an NFP should only change an accounting principle if the change is required by a newly issued FASB ASU or the NFP can justify the use of an allowable alternative accounting principle on the basis that it is preferable.

.111 It is important to note that the correction of an error in the application of an accounting principle in previously issued financial statements is not an accounting change, as distinguished from the change between two or more allowable methods of applying an accounting principle. The reporting of an error correction involves adjustments to previously issued financial statements similar to those generally applicable to reporting an accounting change retrospectively.

.112 Additionally, TIS section 6140.23, "Changing Net Asset Classifications Reported in a Prior Year" (AICPA, *Technical Practice Aids*), was issued in June 2010 and is useful when determining whether a change in the classification of net assets reported in a previous year is an error correction. This guidance concludes that individual net asset classes, rather than net assets in the aggregate (total net assets), are relevant in determining whether an NFP's correction of previously reported net asset classifications is considered an error in the previously issued financial statements.

Classification of Debt in the Statement of Financial Position

.113 Due, in part, to the recent economic recession, some NFPs have noted changes in loan terms for new debt or for existing debt that has been recently renewed. NFPs are reminded to carefully review the terms of their debt agreements to ensure the related liability balances are properly classified in the statement of financial position as current or noncurrent. FASB ASC 470-10-45 provides guidance regarding the following topics to assist with determining proper classification:

- Debt covenant violations
- Due on demand loan agreements
- Callable debt agreements

- Short-term obligations expected to be refinanced

Accounting for Guarantees

.114 NFPs may enter into guarantee contracts on behalf of another organization. For example, NFP A may guarantee the debt of NFP B so that NFP B may obtain a more favorable interest rate. In general, FASB ASC 460, *Guarantees*, requires a guarantor to recognize a liability for the guarantee in the statement of financial position. The liability consists of two parts: (1) an obligation to stand ready to perform over the term of the guarantee and (2) an obligation to make future payments if triggering events or conditions occur. FASB ASC 460 provides guidance on the initial and subsequent measurement of the liability.

.115 FASB ASC 460-10-25-1 does provide scope exceptions for guarantees that are not subject to the recognition requirements. The exceptions include, but are not limited to, guarantees issued between parent and subsidiary organizations or between organizations under common control, a parent organization's guarantee of a subsidiary's debt to a third party, or a subsidiary organization's guarantee of a parent's debt to a third party.

Reporting Costs Paid by One NFP on Behalf of Another in Circumstances in Which the NFPs Are Affiliates

.116 FASB ASC 850-10 provides disclosure requirements for related party transactions but does not require that those transactions be given accounting recognition. Per the definition of *related party* in the FASB ASC glossary, affiliates of NFPs are related parties. An *affiliate* is defined as "[a] party that, directly or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with an entity."

.117 The guidance pertaining to related parties does not exempt the reporting of costs paid by one NFP on behalf of another. Accordingly, costs incurred by an NFP on behalf of an affiliated NFP are subject to the guidance pertaining to contributions in FASB ASC 958-605-25-17, which states that "[c]ontributed services (and the related assets and expenses) should be recognized if employees of separately governed affiliated entities regularly perform services (in other than an advisory capacity) for and under the direction of the donee and the recognition criteria for contributed services are met."

.118 FASB ASC 958-605-25-16 provides that contributed services should be recognized if the services meet any of the following criteria:

- They create or enhance nonfinancial assets.
- They require specialized skills, are provided by individuals possessing the skills, and would typically need to be purchased if not provided by donation. Services requiring specialized skills are provided by accountants, architects, carpenters, doctors, electricians, lawyers, nurses, plumbers, teachers, and other professionals and craftsmen.

.119 As an example, suppose a theater has an affiliated foundation. The theater's accounting staff performs all of the accounting tasks for the foundation at no cost to the foundation. One of the criteria in FASB ASC 958-605-25-16 is met because the service requires specialized accounting skills, and the foundation typically would need to purchase that service if it were not provided by the theater. Accordingly, the foundation should recognize an in-kind contribution for the accounting services provided. Alternatively, suppose the theater's janitorial staff tend to the offices of the foundation staff at no cost to the foundation. None of the criteria in FASB ASC 958-605-25-16 are met because the janitorial services do not create or enhance nonfinancial assets nor do they require specialized skills. Accordingly, the foundation would not recognize an in-kind contribution for the janitorial services provided.

Fair Value

.120 FASB ASC 820-10-20 defines *fair value* and establishes a framework for measuring fair value; however, it does not dictate when an entity must measure something at fair value, nor does it expand the use of fair value in any way. The need to understand fair value accounting has increased in importance as alternative

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investments increased in popularity and complexity. *Fair value* is defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Investments in Certain Entities That Calculate Net Asset Value per Share (or its Equivalent)

.121 As a practical expedient, ASU No. 2009-12 permits a reporting entity to measure the fair value of an investment within its scope on the basis of the net asset value (NAV) per share of the investment (or its equivalent) if the NAV is calculated in a manner consistent with the measurement principles of FASB ASC 946, *Financial Services—Investment Companies,* as of the reporting entity's measurement date, including measurement of all or substantially all of the underlying investments of the investee in accordance with FASB ASC 820. If the practical expedient is used, certain attributes of the investment (such as restrictions on redemption) and transaction prices from principal-to-principal or brokered transactions will not be considered in measuring the investment's fair value.

.122 This ASU also requires disclosures about the attributes of investments by major category, such as the nature of any restrictions on the investor's ability to redeem its investments at the measurement date, any unfunded commitments, and the investment strategies of the investees. The major category of investment is required to be determined based on the guidance in FASB ASC 320-10-50-1B. These disclosures are required for all investments within the scope of this ASU. The ASU adds an example of its required disclosures in FASB ASC 820-10-55-64A.

.123 An AICPA practice aid, *Alternative Investments—Audit Considerations,* also is available and is a useful tool for auditors. It focuses on the existence and valuation assertions associated with alternative investments.

.124 TIS sections 2220.18–.27 (AICPA, *Technical Practice Aids*) are available to assist reporting entities when implementing the provisions of FASB ASC 820 to estimate the fair value of their investments in certain entities that calculate NAV. TIS sections 2220.18–.27 apply to investments that are required to be measured and reported at fair value and are within the scope of paragraphs 4–5 of FASB ASC 820-10-15. These questions and answers complement the guidance provided in ASU No. 2009-12.

.125 Recently issued questions and answers can be located on the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Fair Value Measurement for Gifts In Kind

.126 Some NFPs receive a significant amount of gifts in kind (GIK) for use in carrying out their program activities. Examples might include thrift shop operators who receive donations of clothing and household items or international relief and development agencies that receive donations of pharmaceuticals or similar medical supplies. Because these transactions typically result in the NFP recording substantial amounts of revenue and a corresponding program service expense, particular attention should be paid to how fair value has been calculated.

.127 Some donations of GIK are relatively easy to measure at fair value because observable inputs often are readily available, such as donations of marketable securities, automobiles, or real estate.

.128 Other GIK donations are relatively difficult to measure at fair value because observable inputs are not readily available due to the unique characteristics of the donated assets. For example, an NFP may receive donations of certain pharmaceuticals that are not approved by the federal Food and Drug Administration (FDA) for sale in the United States or articles of clothing that are prohibited from being distributed to beneficiaries in the United States by the donor.

.129 It is important for an NFP to have a reasonable and reliable method for assessing the fair value of donated goods. Certain pricing services have been used by NFPs but such services may not provide

supportable and verifiable values. The auditor's assessment of the method used depends on the specific facts and circumstances and could include the following:

- The significance of GIK to the financial statements
- The nature and valuation complexity of the GIK (for example, non-FDA approved pharmaceuticals may be more difficult to value than FDA-approved pharmaceuticals)
- The nature and extent of management's processes and related internal controls associated with valuation of GIK, including its experience with such transactions
- The nature and extent of information available to management to support its valuation process and valuation conclusions

.130 FASB ASC 820-10-20 defines *fair value* as "[t]he price that would be received to sell an asset ... in an orderly transaction between market participants at the measurement date."

.131 In applying the definition of fair value to GIK, NFPs should consider any restrictions on sale or use of the GIK by the NFP. To determine whether restrictions should affect the fair value measurement of the GIK, the NFP should determine whether the restrictions are asset specific or entity specific. FASB ASC 820-10 clarifies that asset-specific restrictions affect the fair value measurement, but entity-specific restrictions do not. FASB ASC 820-10 contains guidance to help NFPs distinguish between asset-specific or entity-specific restrictions for the GIK they are measuring at fair value.

.132 In developing inputs for the fair value measurement, NFPs also should assume the highest and best use of the GIK by the market participants that is physically possible, legally permissible, and financially feasible, in other words, the use that would maximize the economic value of the GIK to the market participants. Generally, this results in looking to commercial markets for fair value inputs, rather than charitable use of the GIK.

.133 Fair value inputs should be based upon the attributes that market participants would use to value the GIK. For the purposes of fair value measurements, *market participants* are buyers in the principal (or most advantageous) market for the GIK that are independent of the reporting entity, knowledgeable, and able and willing to transact for the GIK. Beneficiaries to which the NFP may distribute the GIK often would not qualify as market participants for the fair value measurement because the beneficiaries often are not willing or able to transact (that is, pay money) for the GIK. For example, certain types of pharmaceuticals are distributed to beneficiaries in developing countries. The beneficiaries receiving those pharmaceuticals usually do not have the resources to transact for those pharmaceuticals, and accordingly, the NFP would not consider the beneficiaries market participants for determining fair value. Instead, the NFP would look to commercial markets for these pharmaceuticals. If no commercial market exists for the specific pharmaceuticals, then the NFP may need to consider a hypothetical market using inputs from commercial markets for similar pharmaceuticals.

.134 Valuation techniques used in fair value measurements include the income approach (converts future amounts, such as cash flow or earnings, to a single present amount); the cost approach (current replacement cost of the assets); or the market approach (uses prices and other relevant information generated by market transactions involving identical or comparable assets). Prevalent practice is to use the market approach for valuing GIK.

.135 Inputs to the valuation techniques should prioritize the use of observable inputs over unobservable inputs. NFPs should give highest priority to level 1 inputs (unadjusted quoted prices in active markets for identical assets) and lowest priority to level 3 inputs (management's assumptions about the assumptions market participants would utilize). However, level 1 inputs often are not available for GIK. Level 2 inputs (inputs other than quoted prices included in level 1 that are observable for the asset) generally include quoted prices in active markets for assets similar to the donated GIK or quoted prices for identical or similar assets in markets that are not active. An example would be two buildings of similar size and condition within a downtown real estate market. An example of a level 3 input might include an estimated value provided by

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the donor. However, management has the responsibility to independently assess the reasonableness and accuracy of the value provided by the donor.

.136 In developing methodologies for measuring fair value of GIK, NFPs should consider the guidance in FASB ASC 820-10, bearing in mind that the guidance is principles based and requires NFPs to use judgment in measuring fair value. Accordingly, it is possible that different NFPs can assign different fair values to the same type of GIK.

Fair Value Measurements Disclosures

.137 ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*, was issued to increase the transparency in financial reporting of fair value measurements. FASB noted that due to the different degrees of subjectivity and reliability on level 1, level 2, and level 3 fair value measurements, information about significant transfers among the three levels and the underlying reasons for such transfers would be useful to financial statement users.

.138 This ASU amends FASB ASC 820-10 to require the following new disclosures:

- *Transfers in and out of levels 1 and 2*. A reporting entity should disclose separately the amounts of significant transfers in and out of level 1 and level 2 fair value measurements and describe the reasons for the transfers.
- *Activity in level 3 fair value measurements*. In the reconciliation for fair value measurements using significant unobservable inputs (level 3), a reporting entity should present separately information about purchases, sales, issuances, and settlements (that is, on a gross basis rather than as one net number).

.139 Additionally, the ASU amends FASB ASC 820-10 to clarify certain existing disclosures as follows:

- *Level of disaggregation*. A reporting entity should provide fair value measurement disclosures for each class of assets and liabilities. A class is often a subset of assets or liabilities within a line item in the statement of financial position. A reporting entity needs to use judgment in determining the appropriate classes of assets and liabilities. In determining the appropriate classes for fair value measurement disclosures, the reporting entity should consider the level of disaggregated information required for specific assets and liabilities under other topics.
- *Disclosures about inputs and valuation techniques*. A reporting entity should provide disclosures about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. Those disclosures are required for fair value measurements that fall in either level 2 or level 3.

.140 The ASU defines two levels of disaggregation: portfolio segment and class of financing receivable. A *portfolio segment* is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. *Classes of financing receivables* generally are a disaggregation of portfolio segment.

.141 The amendments in ASU No. 2010-06 are effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements in the rollforward of activity in level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years.

Determining Fair Value in Inactive Markets and Identifying Nonorderly Transactions and Additional Required Disclosures

.142 FASB ASC 820-10-35 discusses inactive markets and distressed transactions and provides guidance for determining when there has been a significant decrease in the volume and level of activity for an asset or

liability, when a transaction is not orderly, and how that information should be incorporated into a fair value measurement.

Disclosures

.143 FASB ASC 820-10-50 requires the following disclosures:

- The valuation technique(s) and inputs used, as well as any changes in valuation technique and related inputs, for all fair value measurements in interim and annual periods.
- All debt and equity securities measured at fair value by "major category" which is now defined the same as "major security types" in FASB ASC 320-10-50-1 and FASB ASC 942-320-50-2, regardless of whether they fall within the scope of FASB ASC 320, *Investments—Debt and Equity Securities*. FASB ASC 320-10-50-1B states that major security types are based on the nature and risks of securities and include, but are not limited to, the following:
  - — Equity securities (segregated by industry type, company size, or investment objective)
  - — Debt securities (segregated by type of issuer, such as U.S. Treasury or corporations)
  - — Mortgage-backed securities (segregated by type, such as residential or commercial)
  - — Collateralized debt obligations
  - — Other debt obligations

Disaggregation by Major Security Type

.144 In determining whether it is necessary to (1) disclose a particular type of security (that is, industry type or type of issuer) and (2) further disaggregate a particular security type into additional categories, all of the following should be considered: the (shared) activity or business sector, vintage, geographic concentration, credit quality, and economic characteristic.

.145 The application of the disaggregation guidance for debt and equity securities requires management to exercise judgment based on the nature and risk of its particular investments. For example, an entity may choose to disaggregate its equity portfolio fair value measurement disclosures by business sector or company size. Alternatively, management may conclude that it does not need to further disaggregate its equity portfolio based on materiality or other considerations or characteristics of its equity security portfolio.

.146 It is important to note that the determination of the appropriate disaggregation disclosure under this guidance based on materiality or other considerations may be affected by the type and nature of organization in which the investments reside. For example, materiality or other considerations or characteristics are different for an NFP than for an employee benefit plan or an investment company. Accordingly, what may be appropriate disaggregation disclosure for an employee benefit plan may not be the same for an NFP, based on materiality or other considerations such the nature of the business and risk profile of type of organization and the investments that reside in the organization.

Financial Reporting Executive Committee Issues Draft Issues Paper on Fair Value Measurements and Disclosures for Certain Issues Pertaining to NFPs

.147 In January 2010, the Financial Reporting Executive Committee (FinREC) (formerly known as the Accounting Standards Executive Committee) of the AICPA issued a draft issues paper, *FASB Accounting Standards Codification Section 820,* Fair Value Measurements and Disclosures*, for Certain Issues Pertaining to Not-for-Profit Entities*. The draft issues paper discusses fair value measurement for certain issues pertaining to NFPs.

.148 Specifically, the paper discusses fair value measurement pertaining to the following:

- Unconditional promises to give cash

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- Beneficial interests in perpetual trusts
- Split-interest agreements

.149 The comment period ended March 17, 2010. The draft issues paper can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/NotforProfit/Pages/NFPFairValueMeasurements.aspx. This project remains on the FinREC agenda. Readers should be alert for the issuance of the final version of the issues paper.

Disclosures About Credit Quality and Allowance for Credit Losses

.150 In July 2010, FASB issued ASU No. 2010-20, *Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires an entity to provide a greater level of disaggregated information about the credit quality of its financing receivables and its allowance for credit losses. The amendments in this ASU apply to all entities with financing receivables. Examples of financing receivables include loans; trade receivables; notes receivable; and receivables relating to a lessor's leveraged, direct financing, and sales-type leases. Examples of financing receivables for not-for-profit organizations include church mortgages held by church development funds, student loans issued by college and universities, microfinance loans advanced by exempt organizations, and program related investments issued by foundations. See the "Pending Content" in paragraphs 13–15 of FASB ASC 310-10-55 for more information on the definition of *financing receivable*, including a list of items that are excluded from the definition (for example, debt securities). In addition, the "Pending Content" in paragraphs 7–12 of FASB ASC 310-10-55 illustrates certain disclosures required by this ASU.

.151 The ASU amends the existing disclosures to require an entity to provide the following disclosures about its financing receivables on a disaggregated basis:

- A rollforward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method. For each disaggregated ending balance, the related recorded investment in financing receivables should also be disclosed.
- The nonaccrual status of financing receivables by class of financing receivables.
- Impaired financing receivables by class of financing receivables.

.152 The amendments in this ASU require an entity to provide the following additional disclosures about its financing receivables:

- Credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables (see FASB ASC 310-10-55-19 for examples of credit quality indicators)
- The aging of past due financing receivables at the end of the reporting period by class of financing receivables
- The nature and extent of troubled debt restructurings that occurred during the period by class of financing receivables and their effect on the allowance for credit losses
- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period by class of financing receivables and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment

.153 An entity must also describe, by portfolio segment, its accounting policies and methodology used to estimate its allowance for credit losses, including the identification of any changes to the entity's accounting policies or methodology from the prior period and the entity's rationale for the change.

.154 For public entities, the disclosures as of the end of a reporting period are effective for interim and annual reporting periods ending on or after December 15, 2010. The disclosures about activity that occurs during a reporting period are effective for interim and annual reporting periods beginning on or after December 15, 2010. For nonpublic entities, the disclosures are effective for annual reporting periods ending on or after December 15, 2011.

Convergence With International Financial Reporting Standards

.155 Since the signing of the Norwalk Agreement by FASB and the International Accounting Standards Board (IASB), the bodies have had a common goal—one set of accounting standards for international use. *International convergence of accounting standards* refers to both the goal of this project and the path taken to reach it. The path toward reaching this goal will both improve U.S. GAAP and International Financial Reporting Standards (IFRSs) and eliminate the differences between them. In the Norwalk Agreement, each body acknowledged its commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB have undertaken several joint projects, which are being conducted simultaneously in a coordinated manner to further the goal of convergence of U.S. GAAP and IFRSs. The "On the Horizon" section of this alert discusses these joint projects. For more information, visit www.fasb.org and www.iasb.org.

FASB Not-for-Profit Advisory Committee

.156 The FASB Not-for-Profit Advisory Committee (NAC) was established in October 2009 to serve as a standing resource for FASB in obtaining input from the NFP sector on existing guidance, current and proposed technical agenda projects, and longer-term issues affecting those organizations.

.157 The primary functions of NAC are as follows:

- Provide focused input and feedback to the FASB board and staff on existing guidance, current and proposed technical agenda projects, and longer-term issues (for example, the alternatives and recommended course for the financial reporting for NFPs if the Securities and Exchange Commission (SEC) mandates IFRSs for public business entities)
- Assist FASB's board and staff in its communication and outreach activities to the NFP sector about recent and other existing guidance, current and proposed projects, and longer-term issues

.158 More information about NAC and other FASB advisory groups is available at www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176154493483.

Private Company Financial Reporting

.159 The AICPA and the Financial Accounting Foundation (FAF) established the "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of U.S. users of private company financial statements. This panel is also sponsored by the National Association of State Boards of Accountancy. The "blue-ribbon panel" provided recommendations to the FAF board of trustees through an issued report on the future of standard setting for private companies, including whether separate, stand-alone accounting standards for private companies are needed.

.160 The panel has discussed how smaller entities are struggling to understand and implement complex standards, which has resulted in entities making more GAAP exceptions. Other key items include (*a*) whether U.S. GAAP is meeting private company user needs in a cost-beneficial manner for both users and preparers, (*b*) how private company standard setting in the United States compares to standard setting in other countries, and (*c*) possible lessons to be learned from alternatives seen in other countries.

.161 In January 2011, the panel released its report containing three primary recommendations to the FAF board of trustees.

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.162 In March 2011, the FAF board of trustees announced the formation of a Trustee Working Group to address the important topic of accounting standard setting for nonpublic entities. Even though the panel had decided to limit its work to private for-profit companies, the FAF board of trustees elected to include NFPs in the scope of the working group. The establishment of the working group is the next phase of the FAF's review of the adequacy and effectiveness of FASB efforts in setting standards for the private company and nonprofit sectors in the United States. Any resulting potential significant changes to the standard-setting process and structure are expected to be exposed for public comment. The full text of the report is available at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/DownloadableDocuments/Blue_Ribbon_Panel_Report.pdf.

Recent Pronouncements

.163 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org, the FASB website at www.fasb.org, and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.164 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 121, *Revised Applicability of Statement on Auditing Standards No. 100, Interim Financial Information* (AICPA, *Professional Standards*, AU sec. 722) Issue Date: February 2011 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard further amends SAS No. 100 by amending paragraph .05 of AU section 722 such that AU section 722 would be applicable when the accountant audited the entity's latest annual financial statements and the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. SAS No. 121 is effective for interim reviews of interim financial information for periods beginning after December 15, 2011. Early application is permitted.
SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. It also supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to be fairly presented in accordance with the applicable

(continued)

Recent Auditing and Attestation Pronouncements and Related Guidance	
Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), this SAS also supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 118 Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801) Issue Date: April 2010	SSAE No. 16 supersedes the guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. Reports prepared in accordance with SSAE No. 16 may provide appropriate evidence under AU section 324. It is effective for service auditors' reports for periods ending on or after June 15, 2011. Earlier implementation is permitted.
Interpretation No. 8, "Including a Description of Tests of Controls or Other Procedures and the Results Thereof, in an Examination Report," of AT section 101, *Attest Engagements*, (AICPA, *Professional Standards*, AT section 9101 par. .70–.72) Issue Date: July 2010 (Interpretive publication)	This interpretation addresses whether a practitioner performing an examination engagement under AT section 101 may include a description of tests of controls or other procedures, and the results thereof, in a separate section of the examination report, and includes relevant considerations in determining whether to do so.

Recent ASUs

.165 The following table presents, by codification area, a list of recently issued ASUs, through the issuance of ASU No. 2011-01, *Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*. However, this table does not include ASUs that are SEC updates (such as ASU No. 2010-19, *Foreign Currency [Topic 830]: Foreign Currency Issues: Multiple Foreign Currency Exchange Rates [SEC Update]*) or ASUs that are technical corrections to various topics. FASB ASC does include SEC content to improve the usefulness of FASB ASC for public companies, but the content labeled as SEC staff guidance does not constitute rules or interpretations of the SEC nor does such guidance bear official SEC approval.

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Recent Accounting Standards Updates	
Assets Area of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC)	
Accounting Standards Update (ASU) No. 2011-01 (January 2011)	*Receivables (Topic 310): Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings in Update No. 2010-20*
ASU No. 2010-20 (July 2010)	*Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
ASU No. 2010-18 (April 2010)	*Receivables (Topic 310): Effect of a Loan Modification When the Loan Is Part of a Pool That Is Accounted for as a Single Asset—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-28 (December 2010)	*Intangibles—Goodwill and Other (Topic 350): When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts (a consensus of the FASB Emerging Issues Task Force)*
Equity Area of FASB ASC	
ASU No. 2010-01 (January 2010)	*Equity (Topic 505): Accounting for Distributions to Shareholders with Components of Stock and Cash—a consensus of the FASB Emerging Issues Task Force*
Revenue Area of FASB ASC	
ASU No. 2010-17 (April 2010)	*Revenue Recognition—Milestone Method (Topic 605): Milestone Method of Revenue Recognition—a consensus of the FASB Emerging Issues Task Force*
Expenses Area of FASB ASC	
ASU No. 2010-13 (April 2010)	*Compensation—Stock Compensation (Topic 718): Effect of Denominating the Exercise Price of a Share-Based Payment Award in the Currency of the Market in Which the Underlying Equity Security Trades—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-27 (December 2010)	*Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers (a consensus of the FASB Emerging Issues Task Force)*
Broad Transactions Area of FASB ASC	
ASU No. 2010-29 (December 2010)	*Business Combinations (Topic 805): Disclosure of Supplementary Pro Forma Information for Business Combinations (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-10 (February 2010)	*Consolidation (Topic 810): Amendments for Certain Investment Funds*
ASU No. 2010-02 (January 2010)	*Consolidation (Topic 810): Accounting and Reporting for Decreases in Ownership of a Subsidiary—a Scope Clarification*
ASU No. 2010-11 (March 2010)	*Derivatives and Hedging (Topic 815): Scope Exception Related to Embedded Credit Derivatives*
ASU No. 2010-06 (January 2010)	*Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*
ASU No. 2010-09 (February 2010)	*Subsequent Events (Topic 855): Amendments to Certain Recognition and Disclosure Requirements*
Industry Area of FASB ASC	
ASU No. 2010-16 (April 2010)	*Entertainment—Casinos (Topic 924): Accruals for Casino Jackpot Liabilities—a consensus of the FASB Emerging Issues Task Force*

(continued)

Recent Accounting Standards Updates	
ASU No. 2010-03 (January 2010)	*Extractive Activities—Oil and Gas (Topic 932): Oil and Gas Reserve Estimation and Disclosures*
ASU No. 2010-26 (October 2010)	*Financial Services—Insurance (Topic 944): Accounting for Costs Associated with Acquiring or Renewing Insurance Contracts (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-15 (April 2010)	*Financial Services—Insurance (Topic 944): How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-24 (August 2010)	*Health Care Entities (Topic 954): Presentation of Insurance Claims and Related Insurance Recoveries (a consensus of the FASB Emerging Issues Task Force)*
ASU No. 2010-23 (August 2010)	*Health Care Entities (Topic 954): Measuring Charity Care for Disclosure—a consensus of the FASB Emerging Issues Task Force*
ASU No. 2010-07 (January 2010)	*Not-for-Profit Entities (Topic 958): Not-for-Profit Entities: Mergers and Acquisitions*
ASU No. 2010-25 (September 2010)	*Plan Accounting—Defined Contribution Pension Plans (Topic 962): Reporting Loans to Participants by Defined Contribution Pension Plans (a consensus of the FASB Emerging Issues Task Force)*

Recently Issued Technical Questions and Answers

.166 The following table presents a list of nonauthoritative accounting and audit and attest technical questions and answers recently issued by the AICPA. Recently issued questions and answers can be accessed at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/Pages/RecentlyIssuedTechnicalQuestionsandAnswers.aspx.

Recently Issued Technical Questions and Answers **(AICPA,** ***Technical Practice Aids*****)**	
Accounting	
Technical Questions and Answers (TIS) section 6910.18 (Revised October 2010)	"Disclosure of an Investment in an Issuer When One or More Securities or One or More Derivative Contracts Are Held—Nonregistered Investment Partnerships"
TIS section 6931.12 (July 2010)	"Accounting and Disclosure Requirements for Health and Welfare Plans Related to the COBRA Premium Subsidy Included in the American Recovery and Reinvestment Act of 2009"
TIS section 9070.06 (June 2010)	"Decline in Market Value of Assets Subsequent to the Balance Sheet Date"
TIS section 6140.25 (June 2010)	"Multiyear Unconditional Promises to Give—Measurement Objective and the Effect of Changes in Interest Rates"
TIS section 6140.24 (June 2010)	"Contributions of Certain Nonfinancial Assets, Such as Fundraising Material, Informational Material, or Advertising, Including Media Time or Space for Public Service Announcements or Other Purposes"
TIS section 6140.23 (June 2010)	"Changing Net Asset Classifications Reported in a Prior Year"

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Recently Issued Technical Questions and Answers **(AICPA, *Technical Practice Aids*)**	
TIS section 6930.02 (June 2010)	"Defined Benefit Plan Measurement of a Life Insurance Policy"
TIS section 5250.15 (June 2010)	"Application of Certain FASB Interpretation No. 48 (codified in FASB ASC 740-10) Disclosure Requirements to Nonpublic Entities That Do Not Have Uncertain Tax Positions"
TIS section 5250.14 (June 2010)	"Application of Financial Accounting Standards Board (FASB) Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (codified in FASB *Accounting Standards Codification* [ASC] 740-10) to Taxes Other Than Income Taxes"
TIS section 2240.06 (June 2010)	"Measurement of Cash Value Life Insurance Policy"
TIS section 2130.40 (June 2010)	"Certificates of Deposit and FASB ASC 320, *Investments—Debt and Equity Securities*"
TIS section 2130.39 (June 2010)	"Balance Sheet Classification of Certificates of Deposit"
TIS section 2130.38 (June 2010)	"Certificates of Deposit and Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*"
TIS section 1800.05 (June 2010)	"Applicability of Fair Value Disclosure Requirements and Measurement Principles in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Certain Financial Instruments"
Audit and Attest	
TIS section 9110.17 (July 2010)	"Application of Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 740-10 (previously, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*), to Other Comprehensive Basis of Accounting (OCBOA) Financial Statements–Recognition and Measurement Provisions"
TIS section 1400.33 (July 2010)	"Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting"
TIS section 1800.06 (July 2010)	"Applicability of Fair Value Disclosure Requirements in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 820, *Fair Value Measurements and Disclosures*, to Financial Statements Prepared in Conformity With a Comprehensive Basis of Accounting Other Than Generally Accepted Accounting Principles"
TIS section 8700.03 (June 2010)	"Auditor's Responsibilities for Subsequent Events Relative to a Conduit Debt Obligor"

Recent AICPA Independence and Ethics Developments

.167 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at 888.777.7077 or visiting www.cpa2biz.com.

Establishing and Maintaining Internal Control

.168 One of the Professional Ethics Executive Committee's (PEEC's) current projects deals with a possible inconsistency within Interpretation No. 101-3, "Performance of Nonattest Services" under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05). Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. The PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as "maintaining internal control" for the client.

.169 To address the possible inconsistency in Interpretation No. 101-3, the PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members better distinguish between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

.170 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

.171 Exposure drafts issued by the PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

On the Horizon

.172 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to NFPs or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.173 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Overhaul Project—AICPA Audit and Accounting Guide Not-for-Profit Entities

.174 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Not-for-Profit Entities*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1996. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Auditing and Attestation Pipeline—Nonissuers

ASB Clarity Project

.175 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the International Standards on Auditing issued by the International Auditing and Assurance Standards Board. The majority of the clarified standards will be issued in a single SAS codified as AU sections, with each section assigned a section number and title. When the new SAS becomes effective, the SASs issued prior to SAS No. 117 will be superseded. The ASB proposes that most redrafted standards become effective at the same time and is working toward completing the project in the

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second half of 2011. Two possible exceptions to that timeframe include the clarity redrafts of AU sections 341, *The Auditor's Consideration of the Entity's Ability to Continue as a Going Concern*, and 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*).

.176 In May 2010, the expected effective date of the clarified standards was revised to be applicable for audits of financial statements for periods ending on or after December 15, 2012. The standards recently issued in clarified format (SAS Nos. 117–120) have different effective dates. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after all redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies. This expected date depends on satisfactory progress being made and will be amended, if necessary. Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence," the discussion paper *Improving the Clarity of ASB Standards*, and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Joint FASB and IASB Accounting Pipeline

FASB and IASB Memorandum of Understanding

.177 The year 2010 was a pivotal year of progress toward the goal of completing the important projects in the "Memorandum of Understanding" (MoU) during 2011. Since its original issuance in 2006, FASB and the IASB have continued to reaffirm their respective commitments to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. FASB and the IASB agreed that the goal of joint projects is to produce common, principles-based standards, subject to the required due process. FASB and the IASB have agreed to intensify their efforts to complete the major joint projects described in the MoU and are committed to developing, and making publicly available, quarterly progress reports on these major projects. The MoU identifies 11 convergence topics:

- Financial instruments
- Consolidations
- Derecognition
- Fair value measurement
- Revenue recognition
- Leases
- Financial instruments with characteristics of equity
- Financial statement presentation
- Balance sheet netting
- Statement of comprehensive income
- Discontinued operations

.178 In early June 2010, the boards issued a joint statement that discusses the boards' recognition of the challenges that arise from seeking effective global stakeholder feedback. In response, the boards developed a modified strategy by prioritizing the major projects in the MoU, staggering the publication of exposure drafts by limiting the number of significant exposure drafts to four per quarter, and issuing a separate discussion paper seeking stakeholder input about effective dates and transition methods. This paper was issued in October 2010 and is intended to solicit information from stakeholders about the time and effort that will be

involved in adapting to several anticipated new accounting and reporting standards and when those standards should become effective. The feedback from this paper, due by January 2011, will be used by FASB to develop an implementation plan for those new standards that is intended to help stakeholders manage the pace and cost of change.

.179 The priority joint projects are financial instruments, revenue recognition, leases, the presentation of other comprehensive income, and fair value measurements. June 2011 or earlier will remain the target completion date for these priority convergence projects; the target completion dates for the nonpriority projects, however, have been extended past June 2011. Additionally, the comments received on exposure drafts will affect the timeline of finalized converged standards. The boards' joint statement states that this action is not expected to negatively affect the SEC's work plan to consider in 2011 whether and how to incorporate IFRSs into the U.S. financial system.

.180 Readers are encouraged to remain current for the remainder of the exposure draft releases and other developments on convergence through the AICPA's website, www.ifrs.com, in addition to the FASB, IASB, and SEC websites. The growing acceptance of IFRSs as a basis for U.S. financial reporting could represent a fundamental change for the U.S. accounting profession.

Financial Instruments Exposure Draft

.181 In January 2011, the IASB and FASB published a proposal for accounting for impairment of financial assets managed in an open portfolio. For U.S. GAAP, this proposal applies to open portfolios of loans and debt instruments that are not measured at fair value with changes in value recognized in net income. This proposal is a supplement to the exposure draft published by the IASB in November 2009 and FASB's exposure draft published in May 2010. The new proposal is the product of an aligned approach between the boards regarding how to account for credit impairment and takes into consideration feedback received on the aforementioned exposure drafts and recommendations by the Expert Advisory Panel.

.182 This proposal strives to solve an important weakness in the current impairment models—which is the delayed recognition of credit losses associated with financial assets. The proposed approach would recognize credit losses from initial recognition of a financial asset. The timing of that recognition would vary according to the differentiation of financial assets into 2 groups, the "good book" and "bad book." For the purpose of determining the impairment allowance, this differentiation is based on their credit characteristics, that is, the degree of uncertainty about the collectability of a financial asset. For the "good book" group, expected credit losses at each reporting date would be recognized on a portfolio basis over a time period at the higher of the time-proportional expected credit losses (depending on the age of the portfolio) and the credit losses expected to occur within the foreseeable future period (being a minimum of 12 months from the entity's reporting date). For the "bad book" group at each reporting date, the impairment allowance should be the entire amount of expected credit losses. The comment period for this supplement ends in April 2011.

.183 FASB expects to issue final guidance that includes credit impairment during 2011.

.184 In May 2010, FASB issued a proposed ASU, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*. The main objective of this proposal is to provide financial statement users with a more timely and representative depiction of an entity's involvement in financial instruments while reducing the complexity in accounting for those instruments. It develops a consistent framework for classifying financial instruments and makes changes to the requirements to qualify for hedge accounting. The main provisions of these amendments are as follows:

- Most financial instruments would be measured at fair value in the statement of financial position each reporting period.
- Changes in fair value of equity securities, certain hybrid instruments, and financial instruments that can be prepaid in such a way that the holder would not recover substantially all of its investment would be recognized in net income each reporting period regardless of an entity's business strategy for those financial instruments.

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- Hybrid financial instruments containing embedded derivatives that would otherwise have been required to be bifurcated under FASB ASC 815-15 would be classified and measured at fair value in their entirety, with changes accounted for through net income.
- For financial instruments for which an entity's business strategy is to hold for collection or payment(s) of contractual cash flows, net income would remain conceptually unchanged because only changes arising from interest accruals, credit impairments, and realized gains and losses would be recognized in net income each reporting period. With the exception of certain liabilities that qualify for the amortized cost option, all other changes in fair value from these instruments would be recognized in other comprehensive income each reporting period.
- Core deposit liabilities would be remeasured each period using a current value method that reflects the economic benefit that an entity receives from this lower cost, stable funding source.
- Interest income would be recognized after considering cash flows that are not expected to be collected (that is, based on an effective yield applied to the debt instrument less any allowance).
- Quantitative-based hedging requirements would be replaced with more qualitative-based assessments that would make it easier to qualify for hedge accounting. The shortcut method and critical terms match method would be eliminated. An entity would be able to designate particular risks as the risk being hedged in a hedging relationship, and only the effects of the risks hedged would be reflected in net income.
- Hedge accounting would be discontinued only if the criteria for hedge accounting are no longer met or the hedging instrument expires or is sold, terminated, or exercised. An entity would not be permitted to discontinue hedge accounting by simply removing the designation of a hedging relationship.

.185 Some specific types of financial instruments, such as pension obligations and leases, would be exempt from the proposed guidance. Additionally, short term receivables and payables would continue to be measured at amortized cost (plus or minus any fair value hedging adjustments). The IASB completed its first phase of classification and measurement with the issuance of IFRS 9, *Financial Instruments*, in November 2009 with the requirements for classifying and measuring financial liabilities added in October 2010. The IASB has also issued exposure drafts on amortized cost and impairment (new joint guidance has since been issued by the boards on impairment as discussed previously), the fair value option for financial liabilities, and hedge accounting.

.186 The effective date of these amendments will be established upon issuance of the final ASU, which is expected in 2011; it is estimated to have an effective date in 2013. However, nonpublic entities with less than $1 billion in total consolidated assets would be granted an additional 4 years to implement certain requirements related to loans and core deposits. Upon its application, an entity would apply the proposed guidance by means of a cumulative-effect adjustment to the statement of financial position for the reporting period that immediately precedes the effective date.

.187 FASB has issued FAQs for the proposed ASU to clarify the proposal by answering common questions received about the proposed guidance. This document can be accessed at www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157295447 (note this question and answer has not been updated for the January 2011 impairment supplementary document). The exposure draft in its entirety, the impairment supplementary document, and project updates can be found at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011123.

Revenue Recognition Exposure Draft

.188 The revenue recognition project is intended to develop a single, common revenue recognition model that can be applied to a wide range of industries and transaction types. The standards resulting from this project will eliminate weaknesses and inconsistencies between the existing standards. A joint discussion paper issued by the boards proposed a single revenue recognition model. A joint exposure draft, *Revenue from*

Contracts with Customers, from the boards was published in June 2010, and the boards aim to issue a final converged standard by the second quarter of 2011. The proposed standard would replace International Accounting Standard (IAS) 18, *Revenue*; IAS 11, *Construction Contracts*; and related interpretations in IFRSs; under U.S. GAAP, it would supersede most of the guidance contained in FASB ASC 605, *Revenue Recognition*. The core principle of the draft standard is that an entity should recognize revenue from contracts when it transfers goods or services to the customer in the amount of consideration the entity receives, or expects to receive, from the customer.

.189 In addition to eliminating weaknesses and inconsistencies between IFRSs and U.S. GAAP, this proposal intends to provide a more robust framework for addressing various revenue recognition issues; improve comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets; and simplify the preparation of financial statements by reducing the number of requirements to which entities must refer. The proposed standard will also amend the existing guidance on recognition of a gain or loss on the sale of some nonfinancial assets that are not an output of the entity's ordinary activities (for example, property, plant, and equipment) to be consistent with the proposed revenue recognition and measurement requirements. To implement the preceding core principle of revenue recognition, an entity would

- identify the contract(s) with the customer.
- identify the separate performance obligations in the contract (*performance obligation* is an enforceable promise [whether explicit or implicit] in a contract with a customer to transfer a good or service to the customer).
- determine the transaction price (*transaction price* is the amount of consideration that an entity receives, or expects to receive, from a customer in exchange for transferring goods or services promised in the contract).
- allocate the transaction price to the separate performance obligations.
- recognize revenue when the entity satisfies each performance obligation by transferring a promised good or service to a customer (a good or service is transferred when the customer obtains control of that good or service).

.190 The proposal also includes guidance on accounting for some costs. An entity would recognize the costs of obtaining a contract as expenses when incurred. For expenses incurred in fulfilling a contract, if they are ineligible for capitalization in accordance with other guidance, an entity would only be able to recognize an asset if those costs relate directly to a contract (or a specific contract under negotiation); generate or enhance resources of the entity that will be used in satisfying performance obligations in the future; and are expected to be recovered. The proposed guidance would differ from current practice in the following ways: (*a*) recognition of revenue only from the transfer of goods or services, (*b*) identification of separate performance obligations, (*c*) licensing and rights to use, (*d*) effect of credit risk, (*e*) use of estimates, (*f*) accounting for costs, and (*g*) disclosure.

.191 As discussed previously, because the revenue recognition project is one of many standards the boards expect to issue as converged and final in 2011, the effective date will be determined through feedback provided to the boards with regard to effective date and transition methods. Comments on the exposure draft were due on October 22, 2010. The boards held public roundtable meetings after the end of the comment period. Updates regarding this project can be found at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011146.

Fair Value Exposure Draft

.192 The fourth and final exposure draft of the second quarter of 2010 was *Fair Value Measurements and Disclosures (Topic 820): Amendments for Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in the exposure draft are intended to result in common fair value measurement and disclosure requirements in financial statements prepared in accordance with U.S. GAAP and IFRSs. Many of the requirements are not intended to result in a change in the application of the

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requirements in FASB ASC 820; however, some are intended to clarify or change the application of existing fair value guidance. Additionally, some wording changes were made to ensure the guidance is described consistently between U.S. GAAP and IFRSs. The most significant proposed amendments include the following:

- Highest and best use and valuation premise
- Measuring the fair value of an instrument classified in shareholders' equity
- Measuring the fair value of financial instruments that are managed within a portfolio
- Application of blockage factors and other premiums and discounts in a fair value measurement
- Additional disclosures about fair value measurements

.193 The amendments would specify that the concepts of highest and best use and valuation premise in a fair value measurement are relevant only when measuring the fair value of nonfinancial assets, not when measuring the fair value of financial assets or liabilities. The FASB ASC glossary defines *highest and best use* as, in broad terms, the use of an asset by market participants that would maximize the value of the asset or the group of assets within which the asset would be used. The rationale for this proposed change is that the highest and best use concept is considered to be irrelevant when measuring the fair value of financial assets or liabilities because these items do not have alternative uses and their fair values are not believed to depend on their use within a group of other assets or liabilities. These changes are not expected to affect the fair value measurement of nonfinancial assets. However, they might affect current practice for reporting entities that apply the in-use valuation premise more broadly.

.194 The amendments related to measuring the fair value of an instrument classified in shareholders' equity would specify that a reporting entity should measure the fair value of its own equity instrument from the perspective of a market participant who holds the instrument as an asset. An example of an instrument that would be measured at fair value and classified in shareholders' equity is equity interests issued as consideration in a business combination. Currently, U.S. GAAP does not contain explicit guidance on this topic, and the proposed amendments are expected to increase the comparability among reporting entities applying U.S. GAAP and IFRSs.

.195 Regarding measuring the fair value of financial instruments that are managed within a portfolio, the proposed amendments would allow an exception to FASB ASC 820 for measuring fair value when a reporting entity manages its net exposure, rather than its gross exposure, to the underlying risks. A reporting entity that holds a group of financial assets and financial liabilities is exposed to interest rate risk, currency risk, or other price risk (market risks) and to the credit risk of each of the counterparties. The proposed guidance is intended to coincide with financial institutions and other similar reporting entities that hold and manage these instruments in that manner. Specifically, a reporting entity could measure the fair value of the financial assets and financial liabilities that are managed in that way on the basis of the price that would be received to sell a net long position (that is, an asset) for a particular risk or to transfer a net short position (that is, a liability) for a particular risk in an orderly transaction between market participants at the measurement date. The proposed amendments would result in U.S. GAAP and IFRSs having the same requirements for measuring the fair value of financial instruments; additionally, these changes would not change how financial assets and financial liabilities that are managed on the basis of a reporting entity's net risk exposure are measured in practice.

.196 The proposed amendments would make changes to the guidance regarding the application of blockage factors and other premiums and discounts in fair value measurements. These changes could have a significant effect on current practice and readers are encouraged to remain alert to developments in this regard. Lastly, the amendments propose additional disclosures about fair value measurements. More information about the following would be required for disclosure:

- The effect on a level 3 fair value measurement of changing one or more unobservable inputs that could have reasonably been used to measure fair value in the circumstances (excluding unquoted

equity instruments, as provided by FASB's financial instruments exposure draft previously discussed)

- Use of an asset in a way that differs from the asset's highest and best use when that asset is recognized at fair value in the statement of financial position on the basis of its highest and best use
- The categorization by level within the fair value hierarchy for items that are not measured at fair value in the statement of financial position but for which the fair value of such items is required to be disclosed

.197 The effective dates of these proposed amendments would be determined after the feedback from the exposure draft is considered. However, when it is effective, it will be effective as of the beginning of the period of adoption, and an entity would recognize a cumulative effect adjustment in beginning retained earnings in the period of adoption if a difference exists in a fair value measurement of an item recorded at fair value as a result of applying these amendments. Additional disclosures would be required on a prospective basis. These amendments are expected to achieve the objective of developing common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. A final ASU is expected to be issued in the first quarter of 2011. Updates regarding this project can be found at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=1176156576143.

Leases Exposure Draft

.198 During the third quarter of 2010, the IASB and FASB published for public comment joint proposals to improve the financial reporting of lease contracts. These proposals would result in a consistent approach to lease accounting for both lessees and lessors—a "right of use" approach. This would result in the liability for payments arising under the lease contract and the right to use the underlying asset being included in the lessee's statement of financial position, therefore providing more complete and useful information to investors and other users of financial statements. Currently, the accounting for a lease depends on its classification; an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position under either IFRSs or U.S. GAAP, whereas a capital lease results in the lessee recognizing an asset and an obligation. Under the proposed guidance, lessees would not be able to use the operating lease method of accounting, which would produce more complete and comparable financial reporting in addition to reducing the opportunity to structure transactions to achieve a desired accounting outcome.

.199 The scope of the new lease guidance includes all leases (including leases of right-of-use assets in a sublease) other than leases of biological and intangible assets, leases to explore for or use natural resources, and leases of some investment properties. Under this new guidance, all lessees would use a single method of accounting for all leases: an asset would be recognized representing the lessee's right to use the leased (underlying) asset for the lease term (the right-of-use asset), and a liability at the present value of the expected lease payments would also be recognized.

.200 A lessor would recognize an asset representing its right to receive lease payments and, depending on its exposure to risks or benefits associated with the underlying asset, would either (*a*) recognize a lease liability while continuing to recognize the underlying asset (a performance obligation approach); or (*b*) derecognize the rights in the underlying asset that it transfers to the lessee and continue to recognize a residual asset representing its rights to the underlying asset at the end of the lease term (a derecognition approach). The assets and liabilities recognized by both lessors and lessees would be measured on the basis that

- assumes the longest possible lease term that is more likely than not to occur, taking into account the effect of any options to extend or terminate the lease.
- uses an expected outcome technique to reflect the lease payments, including contingent rentals and expected payments under term option penalties and residual value guarantees, specified by the lease.
- a remeasurement is triggered when changes in facts or circumstances indicate that there would be a significant change in those assets or liabilities since the previous reporting period.

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.201 For leases of 12 months or less, lessors and lessees would be able to apply simplified requirements. The simplified accounting would allow lessees to ignore the effects of interest on the recorded assets and liabilities and allow the lessee to record the liability for lease payments at the undiscounted amount for lease payments. New disclosures would also be required.

.202 Under this proposal, an entity will be required to adjust the opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had been applied from the beginning of the earliest period presented. Currently, no specific effective date has been stated.

.203 In early 2009, the boards issued a discussion paper on leases; this exposure draft is the result of extensive deliberations that included consideration of input received from investors, preparers, auditors, regulators, and other interested parties since that discussion paper. The comment period closed on December 15, 2010. The boards have also undertaken further outreach activities, including public roundtable meetings to ensure that the views of all interested parties are taken into consideration before the new standard is completed. Also, the boards will share and jointly consider all comment letters received. A final standard is expected in the second quarter of 2011. Project updates can be found at www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011123. The AICPA has developed questions and answers to highlight the important aspects of the proposals, which can be located at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/DownloadableDocuments/EDITED_LEASES_FAQ.pdf.

Balance Sheet Offsetting Exposure Draft

.204 In efforts to eliminate accounting differences due to varying accounting guidance in IFRS and U.S. GAAP, in January 2011, the boards issued a joint proposal to establish a common approach to offsetting eligible assets and eligible liabilities on the balance sheet. Eligible assets include financial assets and derivative assets; eligible liabilities include financial liabilities and derivative liabilities. The proposal would require an entity to present as a single net amount in the balance sheet (*offset*) a recognized eligible asset and a recognized eligible liability when the offsetting criteria are met. These criteria to be met are

- on the basis of the rights and obligations associated with the eligible asset and eligible liability, the entity has a right to or obligation for only the net amount (that is, the entity has an unconditional and legally enforceable right to set off the eligible asset and eligible liability).
- the amount, resulting from offsetting the eligible asset and eligible liability, reflects an entity's expected cash flows from settling two or more separate eligible instruments (that is, the entity intends to either settle the eligible asset and eligible liability on a net basis; or the entity intends to realize the eligible asset and settle the eligible liability simultaneously).

.205 Therefore, in any other situation, eligible assets and eligible liabilities would be required to be presented separately from each other according to their nature as assets or liabilities. Further, in accounting for a transfer or an eligible asset that does not qualify for derecognition, the entity should not offset the transferred asset and the associated liability. Once effective, an entity would need to apply this guidance retrospectively for all comparative periods. The boards will use the feedback received from their outreach on the time and effort involved in implementing proposed requirements and the implementation plan of other new accounting guidance to determine an appropriate effective date. Comments are due by April 28, 2011, and a final standard is expected to be issued in the second quarter of 2011.

Resource Central

.206 The following are various resources that practitioners engaged in the not-for-profit industry may find beneficial.

Publications

.207 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit and Accounting Guide *Not-for-Profit Entities* (2011) (product no. 0126411 [paperback], WNP-XX [online with the associated Audit Risk Alert], or DNP-XX [CD-ROM])
- Audit and Accounting Guide Government Auditing Standards *and Circular A-133 Audits* (2011) (product no. 0127411 [paperback] or WRF-XX [online with the associated Audit Risk Alert])
- Audit and Accounting Guide *Health Care Entities* (2010) (product no. 0126110 [paperback] or WHC-XX [online with the associated Audit Risk Alert])
- Audit and Accounting Guide *Employee Benefit Plans* (2010) (product no. 0125911 [paperback] or WEB-XX [online])
- Audit Guide *Analytical Procedures* (2008) (product no. 012558 [paperback] or WAN-XX [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2010) (product no. 0125210 [paperback] or WDI-XX [online])
- Audit Guide *Compilation and Review Engagements* (2011) (product no. 0128111 [paperback] or WRC-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Compilation and Review Developments—2010/11* (product no. 0223010 [paperback])
- Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310 [paperback] or WGE-XX [online])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- Audit Risk Alert *Employee Benefit Plans Industry Developments—2011* (product no. 0224111 [paperback])
- Checklists and Illustrative Financial Statements *Not-for-Profit Entities* (product no. 0089811 [paperback] or WNP-CL [online])
- *Accounting Trends & Techniques, 64th Edition* (product no. 0099010 [paperback] or WAT-XX [online])
- *IFRS Accounting Trends & Techniques* (product no. 0099010 [paperback] or WIF-XX [online])
- *Not-for-Profit Entities Accounting Trends and Techniques* (product no. 0066110[paperback] or WNT-XX [online])
- *Audit and Accounting Manual* (2010) (product no. 0051310 [paperback], WAM-XX [online], or AAM-XX [loose leaf])

.208 Additional resources for accountants in business and industry are the Financial Reporting Alert series, designed to be used by members of an entity's financial management and audit committee to identify and understand current accounting and regulatory developments affecting the entity's financial reporting.

- Financial Reporting Alert *Current Economic Instability: Accounting Issues and Risks for Financial Management and Reporting—2010* (product no. 0292010 [paperback])
- Financial Reporting Alert *Not-for-Profit Entities Accounting Issues and Risks 2010: Strengthening Financial Management and Reporting* (product no. 0292210 [paperback])

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AICPA Online Professional Library: Accounting and Auditing Literature

.209 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification*,™ which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]).To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.210 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop (2010–2011 Edition)* (product no. 730096 [text] or 180096 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731856 [text], 181856 [DVD/Manual], or 351856 [Additional Manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.
- *International Versus U.S. Accounting: What in the World is the Difference?* (product no. 731668 [text] or 181661 [DVD]). Understanding the differences between IFRSs and U.S. GAAP is becoming more important for businesses of all sizes. This course outlines the major differences between IFRSs and U.S. GAAP.

.211 Among the many courses, the following are specifically related to the NFP industry:

- *Auditing Nonprofits: Tips and Traps* (product no. 731527 [text]). This course will help you better understand essential aspects of auditing in this industry to conduct audits in the most effective manner and offer practical tips to guide you through possible traps encountered in auditing an NFP.
- *Nonprofit Auditing and Accounting Update (2010–2011 Edition)* (product no. 732096 [text] or 182077 [DVD]). Covering all the latest auditing and accounting developments affecting NFPs, this course will give you a complete understanding of changes in the NFP environment. For 2010–11, the course will include recent FASB pronouncements relating to not-for-profits, including mergers and acquisitions; endowments subject to UPMIFA; FASB Interpretation No. 48 and not-for-profits, developments in the A-133 area, recent AICPA pronouncements related to communicating internal control related matters identified in an audit; compliance auditing; RSI, and more.
- *Accounting and Reporting Practices of Not-for-Profit Organizations* (product no. 743278 [text]). Understand and apply the requirements of FASB and AICPA pronouncements to your NFP clients. Consider real world financial statements, cases, and problems faced by CPAs with NFP clients and executives of NFPs.
- *Frequent Frauds Found in Governments and Not-For-Profits* (product no. 733313 [text]). Through an informative case study approach, this course illustrates common frauds that make headlines and damage the reputations of governments and NFPs.

.212 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.213 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that

are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the not-for-profit industry include the following:

- *Nonprofit Auditing: Unique Auditing for a Unique Entity*
- *Fraud in Exempt Organizations: The Governmental and Not-for-Profit Environments*
- *Nonprofit Accounting: Financial Reporting*

.214 To register or learn more, visit www.cpa2biz.com.

Webcasts

.215 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.216 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

Hotlines

Accounting and Auditing Technical Hotline

.217 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.218 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

Industry Conference

.219 The AICPA offers its annual NFPs conference in June in Washington, D.C. The National Not-for-Profit Industry Conference is a comprehensive forum that deals with the challenges facing NFP practitioners and financial executives today. It's where you'll find out the latest information on the effect of tax, management, auditing, and accounting issues pertaining to NFPs. You'll also receive training in operational strategies that are crucial to the well being of an NFP. For additional information about the conference, call 888.777.7077 or visit www.cpa2biz.com.

.220 In November, the AICPA offers its Not-for-Profit Financial Executive Forum in Anaheim, CA. This conference is a unique educational offering focusing on the issues faced by financial executives in NFPs. The objective of the forum is to provide a solutions-based conference that will address a wide variety of relevant topics encountered by the NFP financial executive. The sessions offered will enable increased interaction and

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the exchange of ideas among the participants and seek to provide clarification on the tough subjects. For additional information about the conference, call 888.777.7077 or visit www.cpa2biz.com.

AICPA Government Audit Quality Center

.221 The GAQC is a voluntary membership center for CPA firms and state audit organizations designed to improve the quality and value of governmental audits. Governmental audits are performed under *Government Auditing Standards* and are audits and attestation engagements of federal, state, or local governments; not-for-profit organizations; and certain for-profit organizations, such as housing projects and colleges and universities that participate in governmental programs or receive governmental financial assistance. The GAQC keeps its members informed about the latest developments and provides them with tools and information to help them better manage their audit practice. CPA firms and state audit organizations that join demonstrate their commitment to audit quality by agreeing to adhere to certain membership requirements.

.222 The GAQC has been in existence since September 2004. Since its launch, center membership has grown to almost 1,500 firms from 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, and 16 state audit organizations. The CPA firm portion of the GAQC membership accounts for approximately 85 percent of the total federal expenditures covered in single audits performed by CPA firms in the Federal Audit Clearinghouse database (http://harvester.census.gov/sac/) for the year 2008 (the latest year with complete submission data).

.223 The GAQC's focus is to promote the highest quality audits and to save members time by providing a centralized place to find information that they need, when they need it, to maximize quality and practice success. Center resources include the following:

- E-mail alerts with the latest audit and regulatory developments, including information on the Recovery Act and its effect on your audits
- Exclusive Internet seminars, webcasts, and teleconferences on compliance auditing and timely topics relevant to governmental and not-for-profit financial statement audits (optional CPE is available for a small fee, and events are archived online)
- Dedicated GAQC website at www.aicpa.org/GAQC with resources, community, events, products, and a complete listing of GAQC member firms in each state
- Online member discussion forums for sharing best practices and discussing issues members are facing
- Savings on professional liability insurance

.224 For more information about the GAQC, visit www.aicpa.org/GAQC.

AICPA Industry Expert Panel—Not-for-Profit Entities

.225 For information about the activities of the AICPA Not-for-Profit Entities Industry Expert Panel, visit the panel's Internet page at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/NOTFORPROFIT/Pages/NotforProfit.aspx.

Industry Websites

.226 The Internet covers a vast amount of information that may be valuable to auditors of NFPs, including current industry trends and developments. Some of the more relevant sites for auditors with NFP clients include those shown in the appendix of this alert.

.227 The NFP industry practices of some of the larger CPA firms also may contain industry-specific auditing and accounting information that is helpful to auditors.

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Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Financial Reporting Executive Committee (formerly known as Accounting Standards Executive Committee [AcSEC])	Summaries of recently issued guides, technical questions and answers, and practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/FINREC/Pages/FinREC.aspx
AICPA Accounting and Review Services Committee	Summaries of review and compilation standards and interpretations	www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/AccountingReviewServicesCommittee/Pages/ARSC.aspx
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Better Business Bureau	Information about not-for-profit entities (NFPs) and donors	www.give.org
Board Source	Resources to help strengthen NFPs' boards of directors	www.boardsource.org
Chronicle of Philanthropy	Articles from the *Chronicle of Philanthropy* newspaper and links to other sites	www.philanthropy.com
CompassPoint Nonprofit Services	Workshops, consulting, publications, and other information and resources of interest to managers of NFPs	www.compasspoint.org
CPAnet	Links to other websites of interest to CPAs	www.cpanet.com
Economy.com	Source for analyses, data, forecasts, and information on the U.S. and world economies	www.economy.com
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Government Accountability Office	Policy and guidance materials and reports on federal agency major rules	www.gao.gov

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Website Name	*Content*	*Website*
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org
Guidestar	Information, news, and resources for NFPs and donors	www.guidestar.org
Independent Sector	A forum to encourage giving, volunteering, NFP initiatives, and citizen action	www.independentsector.org
Information for Tax-Exempt Organizations (an IRS site)	A Treasury Department site providing information and answers to frequently asked questions regarding tax-exempt entities	www.irs.gov/charities/index.html
International Accounting Standards Board	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Auditing and Assurance Standards Board	Summaries of International Standards on Auditing	www.iaasb.org
International Federation of Accountants	Information on standards setting activities in the international arena	www.ifac.org
National Association of College and University Business Officers	Provides information geared to colleges and universities, including accounting tutorials on specific situations encountered in higher education accounting	www.nacubo.org
National Center for Charitable Statistics	Provides statistics on revenue and expenses of NFPs	www.nccs.urban.org
Nonprofit Risk Management Center	Provides information to help NFPs control their risks	www.nonprofitrisk.org
The *NonProfit Times* Online	Articles from the *NonProfit Times* newspaper and links to other sites	www.nptimes.com
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
U.S. Office of Management and Budget (OMB)	OMB information and literature, including cost circulars	www.whitehouse.gov/OMB

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AAM Section 8220

Government Auditing Standards and Circular A-133 Developments—2011

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL AND COMPLIANCE REPORTING

Notice to Readers

This Audit Risk Alert replaces Government Auditing Standards *and Circular A-133 Developments—2010*.

This Audit Risk Alert is intended to provide auditors who perform audits under *Government Auditing Standards* or Office of Management and Budget Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations* with an overview of recent economic, technical, industry, regulatory, and professional developments that may affect the audits and other engagements they perform. This Audit Risk Alert also can be used by an entity's internal management to address areas of audit concern.

This publication is an *other auditing publication*, as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Recognition

The AICPA gratefully appreciates the invaluable assistance Susan Reed provided in creating this publication.

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Diane Edelstein

Erica Forhan

John Good

Laura Hyland

Scott Simpson

Feedback

The Audit Risk Alert Government Auditing Standards *and Circular A-133Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your audits conducted in accordance with *Government Auditing Standards* (also known as the Yellow Book) and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments and Non-Profit Organizations* (Circular A-133). This alert also can be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environments in which your clients operate. This alert is an important tool to help you identify the significant risks that may affect the audit and delivers information about emerging practice issues and current auditing and regulatory developments as they relate to audits performed under *Government Auditing Standards* and Circular A-133. You should refer to the full text of auditing pronouncements, as well as the full text of any rules or publications that are discussed in this alert.

.02 This alert concentrates on issues related to financial statement audits performed in accordance with *Government Auditing Standards* and compliance audits performed in accordance with Circular A-133, collectively referred to as a *single audit*. When performing an audit of a state, local government, or not-for-profit entity under generally accepted auditing standards (GAAS) you may wish to refer to the following alerts:

- Audit Risk Alert *State and Local Governmental Developments—2011* (product no. 0224311)
- Audit Risk Alert *Not-for-Profit Entities Industry Developments—2011* (product no. 0224211)
- Audit Risk Alert *Health Care Industry Developments—2010* (product no. 0223410)

.03 Additionally, the Audit Risk Alert *General Accounting and Auditing Developments—2010/11* (product no. 0223310) explains important issues that affect all entities in all industries in the current economic climate. These alerts can be obtained by calling the AICPA at 888.777.7077 or visiting www.cpa2biz.com.

Economic and Industry Developments

The Current Economy

.04 When planning and performing audit engagements, an auditor should understand the specific economic conditions facing the entity. Economic activities relating to factors such as interest rates, availability of credit, overall economic expansion or contraction, inflation, and labor market conditions may have an effect on the entity. The Audit Risk Alerts *State and Local Governmental Developments—2011* (product no. 0224311), *Not-for-Profit Entities Industry Developments—2011* (product no. 0224211), and *Health Care Industry Developments—2010* (product no. 0223410) further discuss the state of the economy and the potential impact on financial statement audits performed under GAAS of governmental, not-for-profit, and other entities receiving governmental funding.

.05 Although it may appear at first glance that the recent turmoil in the economy does not have a direct impact on entities receiving federal funds, the auditor should consider some potential effects. Although certain types of funding may decrease, in other cases, funding may temporarily increase due to the implementation of government programs as a result of economic conditions. An example of this is funding received under the American Recovery and Reinvestment Act of 2009 (the Recovery Act). During the initial years of Recovery Act funding, the audit risks will likely be different than the audit risks that arise when funding for those programs is decreasing or is completely expended.

.06 Funding constraints may have a significant effect on the entity. One of the effects of reduced funding could be a decreased number of staff. This, in turn, may have a large impact on grants management. With fewer staff to get the work done, an increased risk of noncompliance with compliance requirements and an increased risk of fraud within the organization exist. Internal control systems designed to maintain compliance with grant requirements may be strained. With fewer staff having more responsibilities, internal controls are at risk because policies and procedures may not be followed. In summary, when assessing the risks related

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to the audit, the effect of the current economic situation is an important consideration for the auditor in planning and performing the single audit.

Legislative and Regulatory Developments

2010 Exposure Draft of *Government Auditing Standards* Revisions

.07 In August 2010, the Government Accountability Office (GAO) issued an exposure draft of proposed standards revising *Government Auditing Standards*, which was last revised in 2007. The proposed changes contained in the exposure draft would update *Government Auditing Standards* to reflect major developments in the accounting and auditing profession and emphasize specific considerations applicable to the government environment. The proposed revision reflects recent updates to GAAS, and terminology has been updated for consistency with other standards. In addition, the proposed revision attempts to more clearly identify the *Government Auditing Standards* requirements and guidance that supplement AICPA requirements for financial audits. This includes removing duplication with GAAS requirements and clarifying what represents an additional requirement under *Government Auditing Standards*. The use of footnotes also would be revised such that they would only be used to refer to other sections of the document and to other audit standards. Other information that was previously in footnotes was either moved into the text or eliminated.

.08 In addition to the general proposed revisions noted previously, the exposure draft contains changes to *Government Auditing Standards* in specific areas. Although all proposed revisions are not listed here, some of the more significant revisions can be found in subsequent paragraphs.

.09 *Chapter reorganization*. The exposure draft proposes to reorganize chapters 1–2 such that ethical principles (formerly in chapter 2) would appear in chapter 1, along with the foundational concepts of *Government Auditing Standards*. Chapter 2 would emphasize the use and application of *Government Auditing Standards*. Chapter 4 would contain all financial auditing standards that were formerly found in chapters 4–5.

.10 *Independence.* One of the more substantial proposed changes relates to independence. A conceptual framework approach for independence has been added to chapter 3. If the proposed revisions are ultimately finalized, the guidance in "*Government Auditing Standards*: Answers to Independence Standards Questions," issued by the GAO in 2002, would be superseded by the revised *Government Auditing Standards*. See the section, "Independence Standards Under the Proposed Revision to *Government Auditing Standards*," that follows for more details on the proposed revisions to the independence standards.

.11 *Attestation engagements.* The proposed revisions in this chapter would assist in determining whether an engagement is a form of attest engagement (for example, an examination, review, or agreed-upon procedure engagement) or a performance audit and would clearly distinguish the requirements related to each type of attestation work.

.12 *Effective date.* It is expected that the 2011 Revision to *Government Auditing Standards* will be finalized and issued in the summer of 2011. Furthermore, the effective date of the revised standards has not yet been determined. However, it is expected to have an effective date that coincides with the AICPA's Clarity Project, which is for audits of financial statements for periods ending on or after December 15, 2012. See also the section, "ASB Clarity Project," found later in this alert.

Independence Standards Under the Proposed Revision to Government Auditing Standards

.13 Under the new independence framework found in chapter 3 of the proposed revision to *Government Auditing Standards*, the auditor would identify threats to independence and then assess the significance of the threats. If those threats identified are significant to the engagement, the auditor would then determine whether safeguards could be put into place to mitigate the threats to an acceptable level. The proposed framework also provides guidance on certain specific threats and whether those specific threats can be mitigated.

.14 The proposed revision to the "Independence" section identifies certain activities in six nonaudit service categories that would impair the auditor's independence. The prohibited services fall within the following nonaudit service categories:

- Bookkeeping and preparing accounting records
- Preparing financial statements
- Internal audit services
- Internal control monitoring and assessments
- Information technology systems services
- Valuation services

Note that not all of these nonaudit services would be prohibited, just certain services within those categories. For a nonaudit service that is not expressly prohibited, the proposed revision states that the auditor should apply the conceptual framework to conclude whether a potential impairment exists. In some cases, safeguards put into place would mitigate threats to an acceptable level.[1] However, in other cases, safeguards would not be sufficient to reduce the threat to an acceptable level.

.15 One concept that is introduced in the proposed standards that differs from the AICPA Code of Professional Conduct is that of a postimpairment period. This is the period immediately after the auditor provides an independence impairing service. Under the proposed standards, the auditor may perform the audit in a subsequent period only after sufficient safeguards have been identified and put into place to mitigate any threats.

.16 Other differences between the AICPA Code of Professional Conduct and the proposed GAO standards related to independence are that the proposed GAO framework

- contains a type of threat called "structural threat," which addresses the threat associated with an audit organization's placement within a government entity.
- subjects external consultants and specialists who contribute to audits to both the independence standards and the assessment of independence (which would be done in the same manner as that for auditors).
- contains guidance on documentation necessary to support adequate consideration of auditor independence, with requirements that would go beyond those required by the AICPA.

.17 For more information on the proposed revisions to the independence standards as set forth in the 2010 *Government Auditing Standards* exposure draft, a comparison of the proposed standards with AICPA and the International Federation of Accountants standards is available on the AICPA website at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/2010SeptemberComparisonofProposedGAOIndependenceStandardstoAICPAandIFAC.doc. In addition, the Government Audit Quality Center (GAQC) website has an archived webcast, "What You Need to Know About the 2010 Yellow Book Exposure Draft." This webcast is open to the public and available at www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/Pages/WhatYouNeedtoKnowAboutthe2010YBED–MemberWebEvent.aspx.

GAO Study on Indirect Costs

.18 In May 2010, the GAO issued a report, "Nonprofit Sector: Treatment and Reimbursement of Indirect Costs Vary among Grants, and Depend Significantly on Federal, State, and Local Government Practices." The study found that inconsistencies in the use and meaning of the terms *indirect costs* and *administrative costs*, and their relationship to one another, has made it difficult for state and local governments and nonprofits to

[1] It is important to note that although safeguards can reduce or eliminate threats to independence, if the auditor is not independent in accordance with Interpretation No. 3, "Performance of Nonattest Services," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .05), no safeguards can overcome the lack of independence.

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classify costs consistently. As a consequence, varying interpretations exist of what activity costs are indirect versus administrative. Also, because nonprofits have both diverse characteristics and accounting practices, it is not possible to specify which type of costs may be classified as indirect in all cases. Therefore, it may be difficult for recipients to determine those activities eligible for indirect cost reimbursement under a particular grant award.

.19 In addition, state and local governments may or may not allow reimbursement of indirect costs in federal awards passed through to nonprofits. One item the GAO study found is that variations in indirect cost reimbursement exist not only among different grants, but also within the same grant among different states. As a result of the study, the GAO recommended that the OMB bring together various stakeholders to propose ways to clarify and improve understanding of how indirect costs should be treated, particularly for grants passed through from state and local governments to nonprofit entities. As a first step, the OMB has suggested that nonprofits review the report to better understand the issues. This is an issue that auditors may want to make their clients aware of as a client service. For more information on the findings of the study, visit the GAO website at www.gao.gov/new.items/d10477.pdf to view this report.

OMB Improper Payments Initiative

.20 The OMB has issued government-wide guidance related to the implementation of Executive Order 13520, *Reducing Improper Payments*, which was signed by the President on November 20, 2009. This initiative seeks to reduce improper payments by boosting transparency, holding agencies accountable for reducing improper payments, and increasing penalties for contractors who fail to timely disclose improper payments. As part of the initiative, agencies were directed to review current prepayment and preaward procedures and ensure that a thorough review of available databases with relevant information on eligibility occurs before the release of any federal funds. (An example of one such database is the Department of Health and Human Services Office of Inspector General's List of Excluded Individuals/Entities.) Also, agencies were directed to submit certain information to the OMB that includes information on its current procedures related to this issue.

.21 In addition to Executive Order 13520 noted previously, the following guidance or legislation related to the initiative has been issued recently:

- Memorandum M-11-16, dated April 14, 2011, which revises content in Part I and II of Appendix C of OMB Circular A-123, *Requirements for Effective Measurement and Remediation of Improper Payments*.
- Memorandum M-11-04, *Increasing Efforts to Recapture Improper Payments by Intensifying and Expanding Payment Recapture Audits*, was issued on November 16, 2010.
- Public Law 111-204, *Improper Payments Elimination and Recovery Act of 2010*, was signed into law on July 22, 2010.
- Presidential Memorandum, *Enhancing Payment Accuracy Through a "Do Not Pay List,"* was issued on June 18, 2010.
- Memorandum M-10-13, dated March 22, 2010, which is contained in Part III to Appendix C of OMB Circular A-123, *Requirements for Effective Measurement and Remediation of Improper Payments*.
- Presidential Memorandum, *Finding and Recapturing Improper Payments*, dated March 10, 2010.

.22 Although this initiative does not directly affect single audits or related auditees, it does have a definite impact on federal funding agencies and certainly increases the federal focus on reducing improper payments. Further, even though noncompliance noted in a single audit is not defined in the same way as an improper payment, Part 3, "Compliance Requirements" of the 2011 OMB *Circular A-133 Compliance Supplement* (compliance supplement) states the following about improper payments:

> Under OMB guidance, Public Law (Pub. L.) No. 107-300, and other related legislation, Federal agencies are required to take actions to prevent improper payments, review Federal awards for such payments and, as applicable, reclaim improper payments. Improper payment means:

1. Any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements.
2. Incorrect amounts are overpayments or underpayments that are made to eligible recipients (including inappropriate denials of payment or service, any payment that does not account for credit for applicable discounts, payments that are for the incorrect amount, and duplicate payments).
3. Any payment that was made to an ineligible recipient or for an ineligible good or service, or payments for goods or services not received (except for such payments where authorized by law).
4. Any payment that an agency's review is unable to discern whether a payment was proper as a result of insufficient or lack of documentation.

Auditors should be alert to improper payments, particularly when testing the following sections of Part 3-A, Activities Allowed or Unallowed; B, Allowable Costs/Cost Principles; E, Eligibility; and, in some cases N, Special Tests and Provisions.

.23 More information on the Improper Payments initiative, including any new guidance issued, can be found on the Office of Federal Management area of the OMB website under "Key Initiatives" at www.whitehouse.gov/omb/financial_default.

OMB Compliance Supplement Update

.24 The compliance supplement, issued annually by the OMB, is one of the most important pieces of guidance used by an auditor in a single audit. The supplement identifies the compliance requirements that the federal government expects to be considered as part of a compliance audit required by the Single Audit Act. For the programs it includes, the compliance supplement provides a source of information for auditors to understand the federal program's objectives, procedures, and compliance requirements relevant to the audit, as well as audit objectives and suggested audit procedures for determining compliance with these requirements. Part 7, "Guidance for Programs not Included," provides guidance on how to identify the applicable compliance requirements for those programs not included in the supplement and for program-specific audits when a program-specific audit guide is not available.

.25 Each year, agency program information and compliance requirements are updated, as necessary, to keep the compliance supplement current. In addition, the compliance supplement is a key mechanism that the OMB is using to notify auditors of entities with expenditures of Recovery Act funds of additional compliance requirements and related auditor guidance.

Changes in the 2011 Compliance Supplement

.26 The 2011 compliance supplement includes the normal types of changes made by the OMB each year (for example, new, revised, and deleted programs). A few revisions of note are as follows:

- The compliance supplement, including compliance requirements, has been revised to add auditor procedures relating to the new reporting requirements for certain grantees under the Federal Funding Accountability and Transparency Act of 2006 (Transparency Act or FFATA). For more information on FFATA, see the section, "New Requirements for the Federal Funding Accountability and Transparency Act" later in this alert.
- The content in Part 3 related to improper payments has been revised to indicate that federal agencies are required to (*a*) take action to prevent improper payments, (*b*) review federal awards for improper payments, and (*c*) as applicable, reclaim improper payments. (See the preceding section, "OMB Improper Payments Initiative," for more information.)

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- Section L, "Reporting," of Part 3 has been updated for the requirement to use SF-425, *Federal Financial Report,* taking into account that a small number of programs may not be fully transitioned to that form.
- The "Reporting" type of compliance requirement in Part 3 has also been updated to respond to practice questions relating to the Recovery Act quarterly reporting requirement for recipients under Section 1512 of the Recovery Act (that is, Section 1512 reporting). During the past year, some recipients used a lag methodology to prepare the Section 1512 reporting because they did not have "final" actual expenditure amounts within the 10 days allowed for the Section 1512 reporting period (for example, they used finalized data for 2 months of the current quarter and then did not include the final month of the quarter, instead using the finalized data from the last month of the previous quarter). These auditees believed this was an appropriate method for reporting. However, many auditors disagreed and reported findings relating to the use of such an approach. OMB clarifies in the 2011 compliance supplement that this lag methodology is not appropriate and that if used, would be considered a noncompliance finding (although OMB states that it would not be reported with questioned costs and generally not considered to be a material weakness or affect the compliance opinion). The compliance supplement guidance states that
  - when recipients do not have the actual expenditure amounts within the 10 days allowed for the entire 1512 reporting period, the reporting entity can use "best available data" for the full quarter, which can include estimates. For example, if a recipient has 2 months of finalized data and the third month can only be estimated due to the timing of closing the monthly financial data, the supplement states that using this estimation approach is acceptable.
  - the recipient should have a process in place to review the submitted reports (after the reports have been submitted), and determine if any material differences exist that would require the report to be corrected during the continuous correction period. If no material differences exist, there is no need for the recipient to correct a submitted report.
- The "Procurement and Suspension and Debarment" type of compliance requirement in Part 3 has been modified to include additional information related to international agreements and the Buy American Act. It clarifies that with respect to international agreements, the Buy American requirement set out in Title 2 *U.S. Code of Federal Regulations* Part 176.70 may not be applied when the iron, steel, or manufactured goods used in the project are from a party to an international agreement. In these cases, the goods and services of the applicable party are to be treated in the same manner as domestic goods and services. Part 3 provides further information and detailed regulatory citations.
- Part 4, "Agency Program Requirements," includes normal programmatic changes. Additionally, in order to assist the auditor in determining whether reporting under FFATA applies, a new "III.L.5, Subaward Reporting under the Transparency Act," has been added to each program supplement or cluster in Part 4 to indicate whether this reporting is "applicable" or "not applicable." Also noted is that, at the current time, this reporting at the program level may not be applicable for several different reasons, such as (*a*) no subawards exist under the program; (*b*) the program is exempt from this requirement because it is funded by the Recovery Act; or (*c*) the program is other than a grant or cooperative agreement program. As a result, if the basis for not applicable is that the program is other than a grant or cooperative agreement program, this designation may change in the future once additional types of financial assistance are made subject to FFATA's reporting requirements.
- Part 5, "Clusters of Programs," has been updated for normal programmatic revisions.[2]
- Appendix 3, "Federal Agency Contacts for A-133 Audits," was revised to add additional federal contacts. A new table provides contact information by Catalog of Federal Domestic Assistance (CFDA) number for each federal program included in the supplement. The contacts listed in this table have a programmatic background (and may not be familiar with single audit requirements). Previously, the compliance supplement only included contact information for one individual at each federal agency—generally, the agency single audit coordinator. As noted in GAQC Alert No. 168, the

[2] The American Recovery and Reinvestment Act of 2009 has resulted in numerous changes to clusters. It is important for auditors to be sure clusters are properly identified and presented.

GAQC recommends the federal program contact in the new table be contacted only to obtain specific information about the program or its requirements and suggests that auditors direct questions related to auditing to the overall federal agency contact, that is, the federal agency single audit coordinator. Auditors may also find up-to-date contact information for each federal agency single audit coordinator on the Federal Audit Clearinghouse (FAC) website at https://harvester.census.gov/fac/imagemgmt/NSACContactList.pdf.

- A new section was added to Appendix 7 Section I, "American Recovery and Reinvestment Act," to identify programs funded by the Recovery Act that are not covered by single audit requirements (that is, not required to be included in the Schedule of Expenditures of Federal Awards [SEFA] or in the determination of major programs).
- Appendix 7 has also been revised to include a table of federal programs by agency that includes the CFDA number for, and names of, programs not included in the supplement that are funded by the Recovery Act and that could be subject to single audit requirements.
- Another new section was added to Appendix 7 regarding the appropriate audit finding detail to be provided relating to Recovery Act programs. It states that in addition to the required finding detail described in Section .510(b)(1), the finding detail should include explicit identification of applicable Recovery Act programs.

.27 Appendix 5, "List of Changes for the 2011 Compliance Supplement," of the compliance supplement is a key piece of information to help the auditor identify all the changes the OMB has made to the supplement. Because there may be changes to a number of programs listed, including those receiving Recovery Act funding, it is important for auditors to review the most current compliance supplement as part of audit planning.

Reminders Regarding Other Key Compliance Supplement Guidance

.28 *Clarification of low risk auditee criteria*. Appendix 7, "Other OMB Circular A-133 Advisories," of the compliance supplement continues the guidance applicable to all auditees from the prior year regarding low-risk auditee status. The appendix states that in order to meet the low-risk auditee criteria in Section 530 of Circular A-133 in the current year, the prior two years' audits must have met the requirements of OMB Circular A-133, including report submission to the FAC by the due date (based on the nine-month due date criteria or other revised due date if a properly approved extension was received from the cognizant or oversight agency). The compliance supplement also contains suggested procedures that the auditor performs to assist in determining whether the auditee met the FAC submission due date. This issue is a key consideration when planning an audit performed under Circular A-133 because it will affect the scope of the audit.

.29 *Elimination of granting extensions.* Appendix 7 of the compliance supplement also continues to state that the OMB has advised federal agencies that they should not grant any single audit extension requests to grantees for fiscal years 2009–2011.

.30 *Safe harbor for treatment of a large loan and loan guarantee program in type A program determination*. Appendix 7 of the compliance supplement continues the guidance on the consideration of loans and loan guarantees in the type A program determination process. This guidance affects the following provision from Circular A-133:

> The inclusion of large loan and loan guarantees (loans) should not result in the exclusion of other programs as Type A programs. When a federal program providing loans significantly affects the number or size of Type A programs, the auditor shall consider this Federal program as a Type A program and exclude its values in determining other Type A programs.

.31 This updated guidance, as found in Section IV, "Safe Harbor for Treatment of a Large Loan and Loan Guarantee Programs in Type A Program Determination," of Appendix 7, states that in order to promote

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consistency of practice, auditors may consider the following as a safe harbor for treatment of large loans and loan guarantee programs in determining type A programs when planning audits:

- Each individual program that includes loans or loan guarantees (as described in Section .205(b) of Circular A-133) that does not exceed four times the largest nonloan program (a cluster of programs is treated as one program) is not considered to be large. The presumption is that only changes in the number or size of type A programs that result from the exclusion of individual loan and loan guarantee programs that are in excess of four times that of the largest nonloan program are significant.
- Auditors are only required to perform the recalculation of the type A threshold described in Section .520(b)(3) of Circular A-133 when the expenditures for a loan or loan guarantee program are more than four times that of the largest nonloan program (a cluster of programs is treated as one program).
- The recalculation is performed after removing the total of all large loan and loan guarantee programs.

.32 In addition, this section of Appendix 7 includes a number of detailed examples to illustrate how it would be operationalized in various circumstances. These illustrations are useful to assist in understanding how to address loan and loan guarantee programs in the type A program determination process, especially when loan or loan guarantee programs are part of a cluster. Further, auditors with auditees that participate in the U.S. Department of Education Student Financial Assistance (SFA) program may find the illustrations particularly helpful in understanding the complexities of how this safe harbor is applied when the SFA cluster is involved.

New Requirements for the Federal Funding Accountability and Transparency Act

.33 One of the biggest changes in the compliance supplement is in Part 3, "Compliance Requirements," under the "Reporting" type of compliance requirement. This section has been modified to incorporate new compliance requirements and suggested auditor procedures relating to FFATA and subsequent 2008 amendments. FFATA put into place a new federal reporting system for direct recipients of non-Recovery Act federal awards to report certain subawards. (Note that awards made under the Recovery Act continue to be subject to separate reporting requirements as described further in Part 3.) For this purpose, a *subaward* is defined as a legal instrument to provide support for the performance of any portion of the substantive project or program for which a recipient received a grant or cooperative agreement award and that is awarded to an eligible subrecipient. A subaward may also be provided through any legal agreement, including an agreement that the recipient considers a contract.

.34 For grants and cooperative agreements, the effective date was October 1, 2010, for all discretionary and mandatory awards equal to or exceeding $25,000 made with a new Federal Assistance Identification Number on or after that date. Once the requirement applies, the recipient must report, for any subaward under that award with a value of $25,000 or more, each obligating action of $25,000 or more in federal funds. For contracts, implementation was phased in based on their total dollar value. Grant and cooperative agreement recipients and contractors must report information related to a subaward by the end of the month following the month in which the subaward or obligation of $25,000 or greater was made and, for contracts, the month in which a modification was issued that changed previously reported information.

.35 The FFATA Subaward Reporting System (FSRS) collects the required subaward data. Information required to be reported in the FSRS includes the date of the subaward, the subaward amount, the subaward number, and more. Suggested audit procedures have been added that would have the auditor, among other things, select a sample of recipient payments for first-tier subawards to determine whether certain key data elements were accurately reported and are supported by the source documentation, and that the action was reported in the FSRS no later than the last day of the month following the month in which the award or modification was signed.

Comparison of Recovery Act and FFATA Requirements

.36 Section L, "Reporting," in Part 3 of the compliance supplement includes a new table that is intended to assist auditors in distinguishing, for purposes of the Circular A-133 compliance audit, the requirements that

apply to reporting by recipients under the Recovery Act and those that apply to reporting under FFATA. In addition to helping the auditor identify the applicable reporting requirements under both the Recovery Act and FFATA, because some of the requirements related to this reporting apply directly to subrecipients, the table may also be used for purposes of determining applicable requirements under Section M, "Subrecipient Monitoring."

Help Desk—A series of on-demand courses titled, "Insight: Single Audit Fundamentals On-Demand Series," is available that provides background and information on audits performed under OMB Circular A-133. The training is designed as an introduction to certain single audit topics, including the basics of the compliance supplement, and highlights important information an auditor will need to have to function as a staff member on a single audit engagement. This is available on CPA2Biz at www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/AuditAttest/PRDOVR~PC-154260/PC-154260.jsp.

Help Desk—The GAQC has issued a practice aid that provides the tools to assist auditors in documenting internal control over compliance in a single audit. The practice aid, "Documenting and Testing Compliance and Internal Control Over Compliance in a Single Audit" (product no. 006662PDF) is available to both members and nonmembers of the GAQC for a nominal fee in a PDF format that allows the electronic input of documentation. The practice aid is also available at no charge to members of the GAQC on the GAQC. website at www.aicpa.org/GAQC in a Microsoft Excel or Word format. (For information on the GAQC and membership in the GAQC, see the "AICPA GAQC" section of this alert.)

Audit Considerations of the Recovery Act

.37 One challenge for auditors performing single audits of entities with Recovery Act funds continues to be keeping up with, and understanding, the various sources of requirements and guidance that are being issued on an ongoing basis. The guidance issued is targeted at various stakeholders (for example, federal awarding agencies, award recipients, and auditors), and in many cases, one piece of issued guidance will affect more than one of these stakeholder groups. Since March 2010, the following memorandums have been issued by the OMB:

- M-10-34, *Updated Guidance on the American Recovery and Reinvestment Act* (September 24, 2010)
- M-10-17, *Holding Recipients Accountable for Reporting Compliance under the American Recovery and Reinvestment Act* (May 4, 2010)
- M-10-14, *Updated Guidance on the American Recovery and Reinvestment Act* (March 22, 2010)

.38 These, along with previously issued memorandums, are available on the OMB website at www.whitehouse.gov/omb/recovery_default. In addition, the current year compliance supplement is an important source of updated Recovery Act information. See the preceding section, "Changes in the 2011 Compliance Supplement," for information on some of the Recovery Act-related revisions to the 2011 compliance supplement. Topics that continue to be important to consider in an audit of entities with Recovery Act funds can be found in the following paragraphs.

Audit Risk Considerations Related to Recovery Act Awards

.39 One issue that may need to be considered in the assessment of audit risk involves entities that have fully expended, or are close to fully expending, Recovery Act awards. Upon the initial receipt of Recovery Act awards, some entities increased program resources, including hiring more staff, to carry out the additional program responsibilities. But now some entities have to cut staff positions because Recovery Act funding has either greatly decreased or is fully expended. In this situation, audit risk may increase due to the possibility that some program or organizational responsibilities are not being completed. This may be the case either

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because of understaffing or because the work has not been fully redistributed to remaining staff. See the previous section, "The Current Economy," for a related discussion.

Effect of Recovery Act Expenditures on Major Program Determination

.40 If your auditee has expended Recovery Act funds, there are significant implications on the major program determination process for your single audit. Appendix 7 of the 2011 compliance supplement continues the guidance from the previous year on the effect of Recovery Act expenditures on the major program determination process. That guidance states that due to the inherent risk associated with the transparency and accountability requirements governing expenditures of Recovery Act awards, any program or cluster with expenditures of Recovery Act awards would not qualify as a low risk type A program. Even a de minimus amount of Recovery Act expenditures would not support identifying the program as low risk. The following summarizes additional guidance related to major program determination involving programs with Recovery Act expenditures.

.41 *Type A programs with Recovery Act expenditures (excluding student financial assistance)*. Appendix 7 of the compliance supplement states that any program or cluster with expenditures of Recovery Act awards would not qualify as a low risk type A program unless all of the following conditions are met:

- The program or cluster had Recovery Act expenditures in the prior audit period.
- The program or cluster was audited as a major program in the prior audit period.
- The Recovery Act expenditures in the current audit period are less than 20 percent of the total program or cluster expenditures.
- The auditor has followed Sections .520(c) and .525 of Circular A-133 and determined that the program or cluster is otherwise low risk.

.42 *Type B programs with Recovery Act expenditures.* Appendix 7 of the compliance supplement states that the auditor should consider all type B programs and clusters with Recovery Act expenditures to be programs of higher risk. The presumption is that type B programs or clusters with Recovery Act expenditures would be audited as a major program when applying the provisions of Section .520(e)(2) of Circular A-133. However, the compliance supplement does note that the auditor is not precluded from auditing as a major program an especially risky type B program or cluster that does not contain Recovery Act expenditures, in lieu of a type B program with Recovery Act expenditures.

Help Desk—The AICPA GAQC has established the GAQC Recovery Act Resource Center to provide members with a one-stop repository location with information related to the Recovery Act that may be of interest to auditors. For more information, go to the following section of the GAQC website at www.aicpa.org/INTERESTAREAS/GOVERNMENTALAUDITQUALITY/RESOURCES/RECOVERY ACTRESOURCECENTER/Pages/default.aspx.

Identification of Recovery Act Awards on the Data Collection Form

.43 Guidance issued by the OMB related to the Recovery Act, including the compliance supplement, has made it clear that Recovery Act funds should be listed separately from other types of funds in the SEFA. That is, it states that the SEFA should include a separate line on the schedule for Recovery Act program expenditures and include the prefix "ARRA" in the title of the federal program.

.44 However, there has been some confusion regarding how Recovery Act awards are to be presented in the Data Collection Form (form SF-SAC). Appendix 7 of the compliance supplement states that Recovery Act funds should be listed on a separate row under Item 9 on page 3 of the Form SF-SAC and include the prefix "ARRA" as the first characters in Item 9 of Part III.

.45 The SF-SAC form issued for audit years 2010–2012 (2010–2012 SF-SAC form) has created some confusion about this requirement. On the 2010–2012 SF-SAC form, there continues to be a column that asks if each program is funded by the Recovery Act. Unlike the previous form, which automatically added the "ARRA" prefix to the federal program name when that box was checked "yes," the 2010–2012 SF-SAC form does not add the ARRA prefix. This is because the purpose of the ARRA column on the 2010–2012 SF-FAC form is to create an electronic data element so that the FAC can track Recovery Act program expenditures and other related information (the previous version of the form's ARRA column did not provide for this kind of tracking).

.46 The question that has arisen is whether the ARRA prefix should be inserted before the program name in column (e) of the 2010-2012 SF-SAC form. This, ultimately, is a firm policy decision. However, many firms have decided, based on the technical requirements in the compliance supplement described previously, to require their staff to insert the ARRA prefix before the federal program name on the 2010-2012 SF-SAC form, even though the form has the separate ARRA column, which now allows the FAC to track the funds. This is the most conservative approach and would preclude a federal agency from questioning whether the requirement in the compliance supplement was met.

Effect on SEFA Presentation When CFDA Number Is Not Available

.47 In some instances, grant recipients may be unable to obtain the CFDA number for each of its grants. This is sometimes the case for new federal programs and research and development programs. In addition, cost-type contracts normally will not have a CFDA number. When the CFDA number is not available, the auditee has alternatives for presenting the information in the SEFA. The auditee could indicate that the CFDA number is not available and include, if available, another identifying number, such as a contract or grant number. The auditee also could apply the guidance presented in the FAC's data collection form instructions for when a federal program does not have a CFDA number. Specifically, if the program has a contract or grant number, the number shown as the CFDA number could be the awarding agency's 2-digit prefix listed for the agency in an appendix to the form's instructions (or 99, if the agency is not listed) followed by the contract or grant number. If the program does not have a contract or grant number, the number shown as the CFDA number could be the awarding agency's 2-digit prefix (or 99) followed by "UNKNOWN." As a best practice, before utilizing the UNKNOWN option, practitioners might first check the various sources that may provide the correct CFDA number. Those sources may include the compliance supplement; CFDA website (www-.cfda.gov), including the Historical Index of Programs; and the underlying grant records.

Department of Housing and Urban Development Update

HUD Reports Updated for SAS No. 117

.48 In a transmittal dated March 2, 2011, the Department of Housing and Urban Development (HUD) announced that certain of the example reports found in chapter 2 of the *Consolidated Audit Guide for Audits of HUD Programs* (HUD Audit Guide) have been updated, as appropriate, to satisfy the reporting requirements of Statement on Auditing Standards (SAS) No. 117, *Compliance Audits* (AICPA, *Professional Standards*, AU sec. 801). Examples B-D of the HUD Audit Guide are the examples affected. The reports serve as a reference and provide suggested wording for auditors who perform audits of HUD programs using the HUD Audit Guide. The revised example reports are available on the HUD website at www.hudoig.gov/reports/consolidated.php.

.49 HUD continues its project to update the HUD Audit Guide on a chapter-by-chapter basis. Revised chapter 1, *General Audit Guidance*, was issued in April 2011. The requirements in chapter 1 should be applied to audits of entities with fiscal years ending on or after September 30, 2011. Chapter 2, *Reporting Requirement and Sample Reports*, is expected to be issued by HUD in the upcoming year. Once all chapters have been revised, HUD will release a new, revised HUD Audit Guide.

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> **Help Desk**—Auditors can refer to the GAQC HUD information page for the latest news and information regarding the HUD Audit Guide, including the status of chapter revisions, at www.aicpa.org/INTERESTAREAS/GOVERNMENTALAUDITQUALITY/RESOURCES/HUDINFORMATION/Pages/default.aspx.

HUD Requirements For Supervised Mortgagees

.50 Mortgagee Letter 2009-31 (ML 2009-31), issued by HUD in late 2009, resulted in revisions to audit requirements for supervised mortgagees (for example, depository institutions) that participate in the Federal Housing Administration insured loan program effective for fiscal years ending on or after January 2, 2010. The new rules require a financial statement audit performed under *Government Auditing Standards* and a compliance audit under the HUD Audit Guide. Although audits of nonsupervised mortgagees have been subject to these requirements for a number of years, this is a significant change for supervised mortgagees. GAQC Alert No. 159, which has been left open to the public, can be accessed for more information.

Updated Federal Quality Control Review and Desk Review Checklists

.51 The Council of the Inspectors General on Integrity and Efficiency has recently published two guides relating to federal reviews of Circular A-133 audit quality:

- *Guide for Quality Control Reviews of OMB Circular A-133 Audits (2010 Edition)*. This guide is used by federal agencies when reviewing Circular A-133 audits for the purpose of determining if such audits have been conducted in accordance with Circular A-133 and to assist in determining if any follow-up work is needed by the auditor to support the auditor's opinion (available at www.ignet.gov/pande/audit/qcrreview2010.pdf).
- *Guide for Desk Reviews of OMB Circular A-133 Audit Reports (2010 Edition)*. This guide is used by federal agencies when they review audit reports of audits performed under Circular A-133 to determine if they are acceptable under the Circular's reporting requirements and whether any quality issues exist that warrant follow-up audit work or revisions, or both, to the audit report. In addition, the guide is used to identify audits for potential quality control reviews and to identify issues that federal management needs to be aware of (available at www.ignet.gov/pande/audit/singleauditrevguide2010.pdf).

These guides provide auditors with an understanding of the federal expectations for the performance of Circular A-133 audits. Auditors may want to consider using these checklists as part of an inspection and quality control program.

> **Help Desk**—Additionally, auditors may want to consider using AICPA peer review checklists for a similar purpose. These checklists are available on aicpa.org, and the checklists related to single audits also can be accessed via the GAQC website. For access to the checklists, go to www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/AuditPracticeToolsAids/Pages/Peer%20Review%20Checklists.aspx.

Compliance Auditing and Attestation Engagements—For-Profit Entities

.52 For various reasons, including the issuance of the Recovery Act, there has been significant activity by federal agencies in establishing or updating compliance audit or attestation requirements relating to for-profit entities participating in federal programs. Although for-profit entities are not subject to Circular A-133, federal funding agencies sometimes enact their own audit requirements that may require an audit under Circular A-133 (that is, either a single or program-specific audit), or an audit that replicates some of the requirements of Circular A-133. These requirements may include a financial statement audit performed in accordance with *Government Auditing Standards*, in addition to a compliance audit or attestation engagement. Often, the

compliance audit or attestation engagement requirements are provided in the form of a federal guide. When auditors have questions relating to such an engagement, the auditor may consider contacting the federal agency that issued the audit requirement. If a contact is not clearly provided, the federal agency's single audit coordinator is a possible contact person to determine the appropriate individual within the agency for the for-profit guidance. Appendix 3 of the compliance supplement contains contact information for the single audit coordinators of various federal agencies.

.53 Auditors performing these audits may or may not regularly perform governmental or compliance audits. It is important to note that when the audit is subject to *Government Auditing Standards*, the auditors will be subject to all of the additional requirements in *Government Auditing Standards*, including those related to independence and continuing professional education.

Federal Agency Guidance for For-Profit Entities

.54 Several agencies are in the process of establishing or revising audit requirements directed to for-profit entities receiving federal funds. The Department of Commerce issued new audit requirements for for-profit recipients and subrecipients, such as telecommunication companies. In addition, the Department of Agriculture Rural Utilities Service is considering revisions to its existing audit guidance that would extend audit requirements to for-profit recipients of grants. For information on other agency activity in this area, see the following sections.

Department of Education—Updated Audit and Attestation Guides Issued

.55 Two updated Department of Education (ED) compliance attestation guides for lenders holding Federal Family Education Loan Program (FFEL) loans and lender servicers that service such loans were issued in January 2011:

- *Lender Compliance Attestation Engagement Guide for Lenders Holding Federal Family Education Loan Program Loans* (Lender Guide)
- *Lender Servicer Financial Statement Audit and Compliance Attestation Guide for Lender Servicers that Service Federal Family Education Loan Program Loans* (Lender Servicer Guide)

.56 These guides supersede the December 1996 guide, Compliance Audits (Attestation Engagements) for Lenders and Lender Servicers Participating in the Federal Family Education Loan Program, which covered both lenders and lender servicers. The updated guides are effective for fiscal years ending on or after June 30, 2011, with earlier application recommended but not required. GAQC Alert No. 164, which has been left open to the public, provides more information about the specific requirements in these guides. For a copy of the guide(s), visit the Department of Education website at www2.ed.gov/about/offices/list/oig/nonfed/sfa.html and select items C.1 and C.2.

.57 Practitioners should be aware of a reporting requirement related to fraud, abuse, and illegal acts in Section 2.10 of the Lender Guide and Section 2.12 of the Lender Servicer Guide. These sections require that if any fraud, illegal act, or abuse related to the FFEL Program is detected, regardless of dollar value, the auditor must report this immediately to the ED Assistant Inspector General for Investigations. This requirement differs from the direct reporting requirements in *Government Auditing Standards*, which only require the auditor to direct report fraud, illegal acts, or abuse after management and those charged with governance fail their own obligation to report it to external parties as soon as is practicable. This difference is notable because some state confidentiality laws could preclude an auditor from reporting such information directly to the ED without an expressed consent from the auditee. Therefore, practitioners are advised to consider adding language to their engagement letters to address this ED reporting requirement, stating that acceptance of the engagement letter by the auditee grants the auditor permission to directly notify the appropriate ED personnel if the auditor becomes aware of illegal acts, fraud, or abuse that has occurred or is likely to have occurred.

.58 The ED is also working on an update to the guide *Audits of Federal Student Financial Assistance Programs at Participating Institutions and Institution Servicers*. Auditors performing audits of institutions subject to this

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guide should be alert to the issuance of a revised guide, which will be posted to the ED website at www2.ed.gov/about/offices/list/oig/nonfed/index.html.

Department of Energy—Updated Audit Guide Issued

.59 In early 2011, the Department of Energy (Energy) released a new federal audit guide for conducting program compliance audits for for-profit recipients and subrecipients of federal financial assistance from Energy, such as electric utilities, automotive, and manufacturing companies. The guide covers the audits of a number of new Energy programs that were established under the Recovery Act. This guide is effective for all for-profit recipients and subrecipients of financial assistance awards from Energy beginning with fiscal years ending in 2010 (that is, retroactively). For access to the guide and information on the related requirements, visit the Energy website at http://management.energy.gov/policy_guidance/policy_flashes.htm. The guide, and related information, is available by accessing Energy Policy Flash 2011-7 (including attachment) and 2011-46 (including attachments). Policy Flash 2011-7 includes the audit requirements for for-profit recipients and a related document containing frequently asked questions. Policy Flash 2011-46 includes an audit program, information on compliance requirements, and related checklists.

Audit and Attestation Issues and Developments—General

Supplementary and Other Information Related to Financial Statements

.60 In February 2010, the AICPA Auditing Standards Board (ASB) issued a trio of auditing standards related to the auditor's responsibility for other information, supplementary information, and required supplementary information. These three standards supersede AU section 550A, *Other Information in Documents Containing Audited Financial Statements*; AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). All three standards are effective for audits of financial statements for periods beginning on or after December 15, 2010. Early application is permitted.

Other Information in Documents Containing Audited Financial Statements

.61 SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), addresses the auditor's responsibility with respect to other information in documents containing audited financial statements and the auditor's report thereon. In this SAS, *other information* is defined as financial and nonfinancial information (other than the financial statements and the auditor's report thereon) that is included in a document containing audited financial statements and the auditor's report thereon, excluding required supplementary information. *Documents containing audited financial statements* refers to annual reports (or similar documents) that are issued to owners (or similar stakeholders) and annual reports of governments and organizations for charitable or philanthropic purposes that are available to the public that contain audited financial statements and the auditor's report thereon. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS also may be applied, adapted as necessary in the circumstances, to other documents to which the auditor, at management's request, devotes attention.

Supplementary Information in Relation to the Financial Statements as a Whole

.62 SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. For purposes of GAAS, *supplementary information* is defined as information presented outside the basic financial statements, excluding required supplementary information, that is not considered necessary for the financial statements to be fairly presented in accordance with the applicable financial reporting framework. Such information may be presented in a document containing the audited financial statements or separate from the financial statements. An example of this type of information in an audit performed in

accordance with Circular A-133 is the SEFA and the related reporting on the schedule. See the section, "Issuing an 'In Relation To' Opinion on the SEFA Under SAS No. 119" for more information on the impact of this standard on the reporting on the SEFA.

Required Supplementary Information

.63 SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558), addresses the auditor's responsibility with respect to required supplementary information. The SAS defines *required supplementary information* as information that a designated accounting standard setter requires to accompany an entity's basic financial statements. Required supplementary information is not part of the basic financial statements; however, a designated accounting standard setter considers the information to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context, and authoritative guidelines for the methods of measurement and presentation of the information have been established by the standard setter. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. SAS No. 120 explains that when a designated accounting standard setter requires information to accompany an entity's basic financial statements, the objectives of the auditor are to perform specified procedures in order to

- describe in the auditor's report whether required supplementary information is presented, and
- communicate therein when some or all of the required supplementary information has not been presented in accordance with guidelines established by a designated accounting standard setter or when the auditor has identified material modifications that should be made to the required supplementary information for it to be in accordance with guidelines established by the designated accounting standard setter.

.64 One area that sometimes causes confusion relates to information required by a regulator (for example, a SEFA in a Circular A-133 audit or a schedule of net worth in an audit performed under the HUD Audit Guide). Although this information is required by the regulator, it is not considered required supplementary information for SAS No. 120 purposes because only a designated accounting standard setter can determine what required supplementary information is. Therefore, it would not be appropriate for an auditor to use the provisions of SAS No. 120 for supplementary information required by a regulator. Instead, the auditor would use the provisions of SAS Nos. 118 or 119, as appropriate.

Service Organizations

.65 Since 1992, SAS No. 70, *Service Organizations* (AICPA, *Professional Standards*, AU sec. 324), has been the authoritative standard on requirements and guidance for reporting on controls at service organizations and auditing the financial statements of entities that use service organizations to accomplish tasks that may affect their financial statements. This guidance has now been split into an attestation standard and an auditing standard to better reflect the nature of the work being performed. Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), contains the requirements for performance of the examination and reporting on controls at service organizations that are relevant to user entities' internal control over financial reporting. SSAE No. 16 is effective for service auditor's reports for periods ending on or after June 15, 2011, with earlier implementation permitted. Once effective, auditors that are engaged to report on a service organization's controls will no longer follow the guidance in AU section 324 but instead will follow the attestation standards when performing these engagements (hereinafter, referred to as *SSAE No. 16 reports*).

.66 A finalized clarified SAS on service organizations, *Audit Considerations Relating to an Entity Using a Service Organization*, will supersede SAS No. 70 and addresses the user auditor's responsibility for obtaining sufficient appropriate audit evidence in an audit of the financial statements of a user entity that uses one or more service organizations. This SAS will be effective for audits of financial statements for periods ending on or after December 15, 2012. To make practitioners aware of the various professional standards available to them for examining and reporting on controls at a service organization, and to help practitioners select the

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appropriate standard and related report for a particular engagement, the AICPA has introduced a series of three different service organization control (SOC) reports (SOC 1, SOC 2, and SOC 3). This series encompasses new SSAE No. 16, which retains the original purpose of SAS No. 70, and adds two new reporting options.

.67 The following are highlights of the three reporting options:

- *SOC 1 report*. An engagement performed under SSAE No. 16 in which a service auditor reports on controls at a service organization that may be relevant to user entities' internal control over financial reporting. A type 2 report contains a detailed description of the service auditor's tests of controls and results thereof. Use of the report is restricted to specified parties. It is primarily used by user auditors.
- *SOC 2 report*. An engagement performed under AT section 101, *Attest Engagements* (AICPA, *Professional Standards*), in which a service auditor reports on controls at a service organization other than those relevant to user entities' internal control over financial reporting (specifically, controls at a service organization relevant to security, availability, processing integrity, confidentiality, or privacy). A type 2 report contains a detailed description of the service auditor's tests of controls and results thereof. The criteria for these engagements are contained in TSP section 100, *Trust Services Principles Criteria and Illustrations* (AICPA, *Technical Practice Aids*). The AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)* contains guidance to assist service auditors in performing and reporting on these engagements.
- *SOC 3 report*. An engagement performed under AT section 101 in which a service auditor reports on whether an entity maintained effective controls over its system as it relates to the principle being reported on, such as security, availability, processing integrity, confidentiality, or privacy. It does not contain a description of the service auditor's tests and results. The criteria and additional guidance for these engagements are contained in TSP section 100. These are general-use reports.

.68 To help practitioners make the transition from SAS No. 70 to SSAE No. 16, the AICPA has developed the new alert *Service Organizations: New Reporting Options*, which provides practitioners with an overview of the changes to SAS No. 70 and alerts them to reporting options when examining controls at a service organization other than those relevant to financial reporting by user entities. It is intended to help practitioners understand the requirements of SSAE No. 16 and provide professional guidelines that will enhance both consistency and quality in the performance of attest services. This new alert can be purchased by visiting www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/AuditAttest/IndustryspecificGuidance/PRDOVR~PC-0224811/PC-0224811.jsp.

.69 In addition, an ASB task force has revised the existing Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (the SAS No. 70 guide) to reflect the requirements and guidance in SSAE No. 16 by discontinuing the original guide and issuing the new Guide *Service Organizations—Applying Statement on Standards for Attestation Engagements No. 16,* Reporting on Controls at a Service Organization *(SOC 1)*. Also, the Guide *Reporting on Controls at a Service Provider Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)* will address reporting on a service provider's controls over subject matter other than financial reporting. Both guides are available for purchase at www.cpa2biz.com.

Audit and Attestation Issues and Developments—Audits in Accordance With Circular A-133

Issuing an "In Relation To" Opinion on the SEFA Under SAS No. 119

.70 OMB Circular A-133 states that the auditor should determine and provide an opinion on whether the SEFA is presented fairly, in all material respects, in relation to the auditee's financial statements as a whole. SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551), which is effective for audits of financial statements for periods beginning on or after December 15, 2010, is the standard auditors will use to meet this Circular A-133 reporting requirement. In issuing an "in relation to" opinion on the SEFA to meet the requirements of SAS No. 119, the auditor need not apply procedures as extensive as would be necessary to express an opinion on the schedule itself. Auditors

performing Circular A-133 compliance audits should keep in mind that, because the SEFA serves as the primary basis for the auditor's major program determination, there are additional auditor requirements beyond those outlined in SAS No. 119 that need to be considered for the purpose of meeting the compliance audit objectives. Those additional requirements are outlined in appendix C, "Reporting on the Schedule of Expenditures of Federal Awards Under SAS No. 119," of chapter 7, "Schedule of Expenditures of Federal Awards," of the Audit Guide Government Auditing Standards *and Circular A-133 Audits*.

Issuing an "In Relation To" Opinion

.71 In order to opine on whether the SEFA is fairly stated, in all material respects, in relation to the financial statements as a whole, the auditor should determine that all of the following conditions are met:

- The information contained in the SEFA was derived from, and relates directly to, the underlying accounting and other records used to prepare the financial statements.
- The information contained in the SEFA relates to the same period as the financial statements.
- The financial statements were audited, and the auditor served as the principal auditor in that engagement.
- Neither an adverse opinion nor disclaimer of opinion was issued on the financial statements.
- The SEFA will accompany the entity's audited financial statements, or the financial statements will be made readily available. Paragraph A9 of SAS No. 119 notes that audited financial statements are deemed to be readily available if a third party user can obtain the financial statements without any further action by the audited entity. Financial statements posted on an entity's website are considered readily available. However, being available by request does not fit the meaning of readily available.

.72 SAS No. 119 also requires the auditor to

- perform certain procedures that are in addition to the procedures performed during the audit of the financial statements.
- obtain additional representations from the audited entity related to the "in relation to" opinion.
- report on the SEFA in either (*a*) an explanatory paragraph following the opinion paragraph in the auditor's report on the financial statements, or (*b*) in a separate report on the SEFA. (An example of separate reporting is when the SEFA is reported on in the Circular A-133 report, *Report on Compliance With Requirements That Could Have a Direct and Material Effect on Each Major Program and on Internal Control Over Compliance With OMB Circular A-133*.)
- date the auditor's report on supplementary information no earlier than the date on which the auditor completes the procedures required in order to opine on the information.

.73 See SAS No. 119 for more information on the items discussed in this section and for information on what should be included in the report on the supplementary information. SAS No. 119 also provides guidance on what the auditor should do in the event the auditor concludes that the SEFA is materially misstated in relation to the financial statements as a whole.

.74 Prior to SAS No. 119, the report on the SEFA was required to carry the same date as the report on the financial statements. Under SAS No. 119, the report on the schedule may be required to be dated later than the report on the financial statements. This significant change is a result of the provision in SAS No. 119, which states that the report on the SEFA should not be dated earlier than the date on which the auditor completes the required procedures performed in order to opine on the information. Therefore, if the procedures related to the SEFA are completed after the audit work related to the financial statements (for example, in conjunction with other Circular A-133 audit procedures performed at a later date), then the date of the report on the schedule will be after the date of the financial statement report. That is, it will carry the date on which the auditor completed the required SAS No. 119 procedures.

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.75 Although not always possible, auditors should note that it is a best practice to perform the Circular A-133 audit at the same time as the financial statement audit. When the auditor performs the Circular A-133 audit later than the financial statement audit, a risk exists that the auditor will become aware of misstatements, instances of noncompliance, or abuse that have a direct and material effect on financial statement amounts or other financial data significant to the audit objectives. AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*), provides requirements and guidance in situations where, after the date of the reports on the financial statements and on internal control over financial reporting and on compliance and other matters, the auditor becomes aware of such matters.

SEFA Related Resources

.76 Chapter 7 of the 2011 Audit Guide Government Auditing Standards *and Circular A-133 Audits* was revised to include information on the requirements of SAS No. 119 and its effect when providing an "in relation to" opinion on the SEFA, including how the report wording would change. (See appendix C of chapter 7 of the guide.) Additionally, two auditor tools are available in chapter 7 appendix B, "Schedule of Expenditures of Federal Awards Illustrative Tools," to assist auditors in meeting their responsibilities for the SEFA. They are as follows:

- *Audit Program Supplement for the Schedule of Expenditures of Federal Awards in Accordance With OMB Circular A-133*
- *Disclosure Checklist: Schedule of Expenditures of Federal Awards in Accordance With OMB Circular A-133*

.77 See the following section, "Resource Central," for information on obtaining this Audit Guide. Note that the preceding tools have not yet been updated for the guidance in SAS No. 119, as applicable; this update is planned for the near future and will be made available on the GAQC website in advance of the 2012 edition of the Audit Guide Government Auditing Standards *and Circular A-133 Audits*.

.78 Additionally, because the SEFA is an auditee responsibility and the information it is such a significant factor in a single audit, it is important for an auditee to understand its responsibilities for the SEFA. Two illustrative tools for auditees were developed by the GAQC to assist auditees in gaining this understanding. They are as follows:

- *Worksheet for Identifying Federal Program Information*
- *Auditee Disclosure Checklist for the Schedule of Expenditures of Federal Awards*

Although these auditee tools are not available in the Government Auditing Standards *and Circular A-133 Audits* audit guide, they are available, along with the previously described auditor tools, on the GAQC's website at www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/AuditPracticeToolsAids/Pages/Single%20Audit%20Practice%20Aids.aspx.

> **Help Desk—** Auditors may want to inform clients of an archived GAQC event, "Preparing for Your Single Audit: An Auditee Perspective - Member Conference Call" that has been left open to the public. This event covers a wide spectrum of topics that auditees undergoing single audits should be familiar with, including responsibilities for the SEFA. The archived event is available at www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/Pages/PreparingforYourSingleAuditConferenceCall.aspx.

Communicating Audit Requirements Not Included in the Terms of the Engagement

.79 SAS No. 117 was effective for compliance audits for fiscal periods that ended on or after June 15, 2010. It superseded the previous guidance relating to compliance auditing as found in SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, AU sec. 801A). SAS No. 74 stated that "if during a GAAS audit of the financial

statements the auditor becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement, the auditor should communicate to management and those charged with governance that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements." This wording was not retained in SAS No. 117 because the ASB believed that the guidance would be better located in the SAS *The Auditor's Communication With Those Charged With Governance* (redrafted as part of the Clarity Project). Consequently, the ASB exposure draft *Omnibus Statement on Auditing Standards—2011* is proposing to add application material to the clarified SAS *The Auditor's Communication With Those Charged With Governance* (Redrafted) that provides that other findings and issues that should be communicated may include the auditor becoming aware that an entity is subject to an audit requirement that is not encompassed in the terms of the engagement (for example, an audit in accordance with *Government Auditing Standards*, the Single Audit Act, OMB Circular A-133, or other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides). Although this previous requirement does not currently appear in a standard (due to the timing of the effective date of the clarity standards), if an auditor becomes aware that a client is subject to an audit requirement that is not encompassed in the terms of the engagement, the auditor may still consider communicating this information to those charged with governance.

Auditor Reporting When Engaged Only to Perform a Circular A-133 Compliance Audit

.80 There may be instances in which an auditor needs to issue a stand-alone opinion on the SEFA instead of an opinion in relation to the financial statements as a whole. This situation arises when an auditor is engaged to perform the Circular A-133 audit but is not engaged to perform the audit of the entity's financial statements (that is, another firm is engaged to perform the financial statement audit). When this occurs, it is not appropriate for the Circular A-133 auditor to issue an "in relation to" opinion on the SEFA because such reporting can only be done when the auditor also served as the principal auditor in the financial statement engagement. Instead, the Circular A-133 auditor would issue the compliance opinion and reporting on internal control over compliance as required under Circular A-133 and then a stand-alone opinion on the schedule. The stand-alone opinion would be dated the same as the Circular A-133 report. If an auditor encounters this situation, example 14-1 in chapter 14, "Program Specific Audits," of the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits* may be useful. Although it is intended to illustrate providing an opinion on the financial statement of one federal program for a program specific audit, auditors that need to provide a stand-alone opinion on a SEFA could make a few small modifications to example 14-1 (for example, to refer to the SEFA instead of a schedule for one federal program) to develop the appropriate report wording. Additionally, the required reporting under *Government Auditing Standards* on internal control over financial reporting and compliance and other matters would be issued by the financial statement auditor in a situation in which a single audit is required but a separate auditor is engaged to perform the Circular A-133 compliance audit.

Federal Agency Requests for Auditor Certifications

.81 There has been a resurgence of requests by federal agencies to require grantees to have their auditor sign a certification statement. Sometimes, the statements are associated with preaward activities, and the auditor is asked to sign a statement saying that the entity has appropriate controls or financial systems to administer federal programs. Others relate to existing grantees that are asked to have their auditor sign similar statements. There have also been requests made of auditors to provide feedback about the status of significant deficiencies and material weaknesses noted in an audit. In most circumstances, statements such as these are not appropriate for the auditor to sign unless the auditor has been engaged to perform an engagement under professional standards. If you, as an auditor, are asked to sign such a statement or certification, you should not do so unless you have performed an appropriate engagement. If you are the ongoing auditor to a federal recipient and have not been engaged to perform an engagement under professional standards, one option would be to suggest that your client submit its financial statement and related audit report and, if applicable, its SEFA and related Circular A-133 audit reports in lieu of signing the statement or certification. Another option would be to reach out to the federal agency single audit coordinator to make them aware of the problematic request. Finally, you might also make the AICPA GAQC know about the request by sending an

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e-mail to gaqc@aicpa.org so that they can follow-up with the federal agency, as well. The AICPA has issued guidance specifically applying to preaward survey requests in Interpretation No. 7, "Reporting on the Design of Internal Control," of AT section 101 (AICPA, *Professional Standards*, AT sec. 9101 par. .59–.69), which provides useful guidance for such situations.

Informal Interpretations From Federal Agencies

.82 Sometimes auditors contact federal agencies with questions about a particular federal program or Circular A-133 audit requirement, and they receive an informal response. Other times, federal agencies may issue informal guidance to grantees or auditors either from a field office or a federal agency single audit coordinator. Recently, there have been several informal interpretations made by federal agencies that conflict with Circular A-133 requirements. For example, one federal agency instructed grantees and auditors that it wanted the SEFA to be prepared based on federal program receipts instead of expenditures as is required by Circular A-133. Another example was an agency that informed an entity and its auditor that a subrecipient did not have to submit a reporting package to the FAC. In both cases, the guidance provided was in direct conflict with Circular A-133. Auditors are cautioned when receiving informal guidance from a federal agency that conflicts with federal audit regulations, such as Circular A-133, that an informal interpretation cannot override the underlying audit requirement. In such cases, auditors should try to obtain the federal agency interpretation in writing and consider contacting OMB when conflicting guidance has been issued to determine the appropriate course of action.

Federal Agency Follow Up on Findings

.83 There has been an increase in follow-up activities by federal agencies with regard to audit findings related to internal control over financial reporting, internal control over compliance, and compliance. In some cases, the findings being followed up on relate solely to the financial statement audit and not the single audit. Circular A-133 requires that all findings, whether financial statement related or grant related, be reported, and thus, it is within a funding agency's purview to follow up on any findings they determine may be problematic. Clients may ask auditors about how to respond to federal agency follow up on such findings. Auditors might consider advising grantees that they should fully understand the nature of the finding, develop an appropriate corrective action plan, and work directly with the inquiring federal agency to resolve the issue.

Summary of Frequent Violations Relating to Single Audits—Ethics Division

.84 The AICPA Professional Ethics division investigates potential disciplinary matters involving members of the AICPA and state CPA societies participating in the Joint Ethics Enforcement Program. The investigations of audits of government and not-for-profit entities are typically initiated by referral from the offices of inspectors general. The Professional Ethics division has compiled a summary of recent violations that were frequently found in investigations related to governments and not-for-profit entities. Frequent violations relating specifically to single audits are discussed in the following paragraphs.

.85 The listing includes violations related to major program determination and program testing, including violations in which the auditor

- failed to accurately identify and test all major programs in accordance with Circular A-133.
- did not accurately identify and test all major programs as they relate to program clusters (programs were improperly clustered).
- failed to audit enough programs to meet the percentage of coverage rule.
- incorrectly computed the threshold for determining type A programs.

.86 A number of the frequent violations pertained to the SEFA and the Schedule of Findings and Questioned Costs (SFQC). Some of these are violations in which

- the SEFA did not clearly indicate the total federal expenditures for each federal program.
- the SEFA was not accompanied by notes to the schedule.

- the SEFA did not contain the required information related to the federal agency and pass-through entities, including CFDA number or other identifying number.
- the auditor did not properly report audit findings in the SFQC (required elements were missing).
- the auditor incorrectly identified in the SFQC the dollar threshold used to distinguish between type A and type B programs.

Recent Pronouncements

.87 AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers. The Public Company Accounting Oversight Board (PCAOB) establishes auditing and attestation standards for audits of issuers. For information on pronouncements issued subsequent to the writing of this alert, please refer to the AICPA website at www.aicpa.org and the PCAOB website at www.pcaob.org. You also may look for announcements of newly issued accounting standards in the *CPA Letter Daily* and the *Journal of Accountancy*.

Recent Auditing and Attestation Pronouncements and Related Guidance

.88 The following table presents a list of recently issued audit and attestation pronouncements and related guidance.

Recent Auditing and Attestation Pronouncements and Related Guidance	
Statement on Auditing Standards (SAS) No. 121, *Revised Applicability of Statement on Auditing Standards No. 100*, Interim Financial Information (AICPA, *Professional Standards*, AU sec. 722 par. .05) Issue Date: February 2011 (Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])	This standard further amends SAS No. 100 by amending paragraph .05 of AU section 722 such that AU section 722 would be applicable when the accountant audited the entity's latest annual financial statements and the appointment of another accountant to audit the current year financial statements is not effective prior to the beginning of the period covered by the review. SAS No. 121 is effective for interim reviews of interim financial information for periods beginning after December 15, 2011. Early application is permitted.
SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 558) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This standard addresses the auditor's responsibility with respect to information that a designated accounting standard setter requires to accompany an entity's basic financial statements. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the basic financial statements does not cover required supplementary information. The standard supersedes AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole* (AICPA, *Professional Standards*, AU sec. 551) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility when engaged to report on whether supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. The information covered by this SAS is presented outside the basic financial statements and is not considered necessary for the financial statements to

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Recent Auditing and Attestation Pronouncements and Related Guidance	
	be fairly presented in accordance with the applicable financial reporting framework. Along with SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550), this SAS supersedes AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*). This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.
SAS No. 118, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 550) Issue Date: February 2010 (Applicable to audits conducted in accordance with GAAS)	This SAS addresses the auditor's responsibility in relation to other information in documents containing audited financial statements and the auditor's report thereon. In the absence of any separate requirement in the particular circumstances of the engagement, the auditor's opinion on the financial statements does not cover other information, and the auditor has no responsibility for determining whether such information is properly stated. This SAS establishes the requirement for the auditor to read the other information of which the auditor is aware because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information. This SAS supersedes AU section 550A, *Other Information in Documents Containing Audited Financial Statements* (AICPA, *Professional Standards*), and along with SAS No. 119, supersedes AU section 551A. This SAS is effective for periods beginning on or after December 15, 2010. Early application is permitted.

Recent AICPA Independence and Ethics Developments

.89 In May 2010, the AICPA Professional Ethics Executive Committee released revised and clarified independence rules in the code affecting Interpretation No. 101-1, "Interpretation of Rule 101," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .02), as it applies to covered members formerly associated with an attest client and participation of a covered member's immediate family in an employer's benefit plan. The revisions to Interpretation No. 101-1 are effective June 1, 2011, with earlier application allowed.

.90 The Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710) contains a complete update on new independence and ethics pronouncements. This alert will heighten your awareness of independence and ethics matters likely to affect your practice. Obtain this alert by calling the AICPA at 888.777.7077 or visiting www.cpa2biz.com.

On the Horizon

.91 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. The following sections present brief information about some ongoing projects that have particular significance to those entities that received federal funding or that may result in significant

changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.92 Information on, and copies of, outstanding exposure drafts may be obtained from the various standard setters' websites. These websites contain in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard setting bodies for further information.

Overhaul Project—AICPA Audit and Accounting Guide *Not-for-Profit Entities*

.93 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Not-for-Profit Entities*, addressing numerous accounting, auditing, industry, and regulatory issues that have transpired since this guide was originally issued in 1996. During this project, the AICPA will continue to issue annual editions of the guide, updated to reflect recent audit and accounting pronouncements.

Overhaul Project—AICPA Audit and Accounting Guide *Health Care Entities*

.94 The AICPA is continuing to make progress overhauling the AICPA Audit and Accounting Guide *Health Care Entities*. The proposed guide addresses many new accounting and regulatory issues that have transpired since this guide was originally issued in 1996 and includes guidance related specifically to health care entities. A working draft of the accounting sections of the new guide was issued for a 60-day comment period in April 2011. The working draft can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AcctgFinRptg/AcctgFinRptgGuidance/Pages/WorkingDraftHealthCareOrganizations.aspx. Readers should be alert for the issuance of the new guide near the end of 2011.

Auditing and Attestation Pipeline

ASB Clarity Project

.95 In response to growing concerns about the complexity of standards, the ASB has commenced a large-scale clarity project to revise all existing auditing standards so they are easier to read and understand. Over the last few years, the ASB has been redrafting all of the existing auditing sections contained in the *Codification of Statements on Auditing Standards* (AU sections of the AICPA's *Professional Standards*) to apply the clarity drafting conventions and converge with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board. Most of the standards are being clarified "one for one" into individual clarified standards. However, in some cases, several standards have been grouped together to form a single clarified standard, whereas in other cases, certain paragraphs of an existing standard have been carved out of that standard and placed in a different clarified standard. As part of this project, the ASB has revised the AU section number order to follow the ISA number order for all clarified AU sections for which there are comparable ISAs. New AU section numbers have been assigned for all clarified AU sections for which no corresponding ISAs exist.

.96 The majority of the clarified standards will be issued in a single SAS, codified as AU sections, with each section assigned a section number and title. The ASB proposes that most of the redrafted standards become effective at the same time and is working toward completing the project in the second half of 2011. Several exceptions to that time frame exist, including the clarity redrafts of AU section 341, *The Auditor's Consideration of the Entity's Ability to Continue as a Going Concern*, and AU section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*), which are not yet finalized. When the clarity project is complete, all SASs except SAS Nos. 117–120 will be superseded.

.97 The effective date of most of the clarified standards is for audits of financial statements for periods ending on or after December 15, 2012. Standards that have been issued recently in clarified format (SAS Nos. 117–120) have different effective dates, as will any redrafted standards issued at a later date. The ASB believes that having a single effective date for most of the clarified standards will ease the transition to, and implementation of, the redrafted standards. The effective date will be long enough after the redrafted statements are finalized to allow sufficient time for training and updating of firm audit methodologies.

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Further, early adoption of the new SAS will not be appropriate. The SAS that will encompass all clarified AU sections will be issued with the next consecutive number that is available. See the explanatory memorandum "Clarification and Convergence" and the discussion papers *Improving the Clarity of ASB Standards* and *Clarity Project: Questions and Answers* at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx. All clarified SASs that have been finalized by the ASB but are not yet issued as authoritative can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/Final%20Clarified%20Statements%20on%20Auditing%20Standards.aspx.

Resource Central

.98 The following are various resources that practitioners engaged in audits of entities subject to *Government Auditing Standards* and Circular A-133 may find beneficial.

Publications

.99 Practitioners may find the following publications useful. Choose the format best for you—online or print.

- Audit Guide Government Auditing Standards *and Circular A-133 Audits* (2011) (product no. 0127411 [paperback] or WRF-XX [online])
- Audit and Accounting Guide *Not-for-Profit Entities* (2011) (product no. 0126411 [paperback] or WNP-XX [online])
- Audit and Accounting Guide *State and Local Governments* (2011) (product no. 0126611 [paperback] or WGG-XX [online])
- Audit and Accounting Guide *Health Care Entities* (2011) (product no. 0126111 [paperback] or WHC-XX [online])
- Audit and Accounting Guide *Gaming* (2011) (product no. 0127111 [paperback])
- *Documenting and Testing Compliance and Internal Control Over Compliance in a Single Audit* (2010) (product no. 006662PDF [online])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2009) (product no. 012459 [paperback] or WRA-XX [online])
- Audit Guide *Audit Sampling* (2008) (product no. 012538 [paperback] or WAS-XX [online])
- Audit Risk Alert *Not-for-Profit Entities Industry Developments—2011* (product no. 0224211 [paperback])
- Audit Risk Alert *State and Local Governmental Developments—2011* (product no. 0224311 [paperback])
- Audit Risk Alert *Independence and Ethics Developments—2010/11* (product no. 0224710 [paperback] or WIA-XX [online])
- Checklists and Illustrative Financial Statements *Not-for-Profit Entities* (product no. 0089811 [paperback] or WNP-CL [online])
- *Accounting Trends & Techniques: Not-For-Profit Entities* (product no. 0066111 [paperback] or WNT-XX [online])

AICPA Online Professional Library: Accounting and Auditing Literature

.100 The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the Financial Accounting Standards Board (FASB) *Accounting Standards Codification*™ (ASC), the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB* Accounting Standards Codification™, which contains all

Audit and Accounting Guides, all Audit Risk Alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]). To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Continuing Professional Education

.101 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's AnnualAccounting and Auditing Update Workshop(2010–2011 Edition)* (product no. 736186 [text], 187194 [DVD], or 357194 [additional manual for DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *Internal Control Essentials for Financial Managers, Accountants and Auditors* (product no. 731858 [text], 181856 [DVD/manual], or 351856 [additional manual for DVD]). This course will provide you with a solid understanding of systems and control documentation at the significant process level.

.102 Among the many courses, the following are specifically related to audits of entities subject to *Government Auditing Standards* or Circular A-133:

- *Governmental Accounting and Auditing Update* (2011-2012) (product no. 736481 [text], 186487 [DVD], also available On-Demand)
- *Insight: Single Audit Fundamental* On-Demand Series (product no. 154260 [online])
- *Applying A-133 to Nonprofit and Governmental Organizations* (product no. 730913 [text] or 187212 [DVD])
- *Studies on Single Audit and Yellow Book Deficiencies* (product no. 733034 [text])
- *Fraud in the Governmental and Not-For-Profit Environments* (product no. 0731926 [text])

.103 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.104 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. In addition to general accounting and auditing topics, CPExpress offers courses of special interest to those performing audits under *Government Auditing Standards* or Circular A-133.

.105 To register or learn more, visit www.cpa2biz.com.

Webcasts

.106 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

Member Service Center

.107 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

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Hotlines

Accounting and Auditing Technical Hotline

.108 Do you have a complex technical question about generally accepted accounting principles, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST on weekdays. You can reach the Technical Hotline at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/AATechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.109 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

Industry Conference

.110 The AICPA sponsors four annual conferences that include a focus on *Government Auditing Standards* and Circular A-133 topics in the summer and fall of each year.

.111 The National Governmental Accounting and Auditing Update Conference (GAAC) EAST will be held August 22–23, 2011, in Washington, D.C., and its counterpart, GAAC WEST, will be held September 19–20, 2011, in Las Vegas, NV. These conferences are designed for CPAs working in federal, state, and local government; public practitioners with government clients; and regulators who need to be aware of emerging developments. Attending one of these conferences is a great way to receive timely guidance, along with practical advice on how to handle new legislation and standards, from key government officials and representatives of the accounting profession, including the standard setters themselves.

.112 The AICPA National Governmental and Not-for-Profit Training Program will be held October 24–26, 2011, in Orlando, FL. If you need hands-on training and are a CPA in public practice or a governmental or not-for-profit staffer, then this conference is for you. You'll hear directly from the standard setters and industry leaders on a variety of topics, including developments in governmental accounting and auditing; the latest in proposed regulations and laws on the local, state, and federal government levels, as well as those affecting the not-for-profit sector; and more.

.113 The National Not-for-Profit Industry Conference will be held June 21–22, 2012, in Washington, D.C. The conference offers a wide range of topics geared to not-for-profit professionals at every level: tax, management, audit and accounting, fundraising, and regulatory.

.114 For further information about the conferences, call 888.777.7077 or visit www.cpa2biz.com.

AICPA GAQC

.115 The GAQC is a voluntary membership center for CPA firms and state audit organizations designed to improve the quality and value of governmental audits. For the purposes of the GAQC, governmental audits are performed under *Government Auditing Standards* and are audits and attestation engagements of federal, state, or local governments; not-for-profit entities; and certain for-profit organizations, such as housing projects and colleges and universities, that participate in governmental programs or receive governmental financial assistance. The GAQC keeps members informed about the latest developments and provides them with tools and information to help them better manage their audit practice. CPA firms and state audit

organizations that join demonstrate their commitment to audit quality by agreeing to adhere to certain membership requirements.

.116 The GAQC has been in existence since September 2004. Since its launch, center membership has grown to 16 state audit organizations and almost 1600 firms from 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. The CPA firm members of the GAQC account for approximately 88 percent of the total federal expenditures covered in single audits performed by CPA firms in the FAC database (http://harvester.census.gov/sac/) for the year 2008 (the latest year with complete submission data).

.117 The GAQC's focus is to promote the highest quality audits and to save members time by providing a centralized place to find information that they need, when they need it, to maximize quality and practice success. Center resources include the following:

- E-mail alerts with the latest audit and regulatory developments, including information on the Recovery Act and its impact on your audits
- Exclusive webcasts and webinars on compliance auditing and timely topics relevant to governmental and not-for-profit financial statement audits (optional CPE is available for a small fee, and events are archived online)
- Dedicated GAQC website at www.aicpa.org/GAQC with resources (including a Recovery Act Resource Center), community, events, products, and a complete listing of GAQC members in each state
- Single audit practice aids and tools, some of which are described in this alert and are available via the GAQC website
- Online member discussion forums for sharing best practices and discussing issues members are facing
- Savings on professional liability insurance

.118 For more information about the GAQC, visit www.aicpa.org/GAQC.

Help Desk—With all the quality issues being noted in governmental audits (see further discussion in the "Legislative and Regulatory Developments" and "Audit and Attestation Issues and Developments" sections of this alert), your CPA firm or state audit organization should consider joining the center. To enroll or learn more about the GAQC, including details on the membership requirements and fees for membership, go to www.aicpa.org/GAQC or e-mail the GAQC staff at GAQC@aicpa.org. To preview member benefits, go to www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Membership/Pages/Preview%20Center%20Benefits.aspx.

AICPA Industry Expert Panel—State and Local Governments

.119 The State and Local Government Expert Panel is an AICPA volunteer group whose purpose is to identify state and local government financial reporting and auditing issues and to work with appropriate bodies for resolutions benefiting the public interest; conduct liaison activities with the Governmental Accounting Standards Board, regulators such as the GAO and OMB, and applicable industry associations; and advise and assist in the development of AICPA products and services related to state and local government audits. For information about the activities of the State and Local Government Expert Panel, visit the AICPA website at www.aicpa.org/InterestAreas/AccountingAndAuditing/Community/StateAndLocalGovernment/Pages/StateandLocalGovernment.aspx.

AICPA Industry Expert Panel—Not-for-Profit Entities

.120 The AICPA Not-for-Profit Entities Industry Expert Panel assists those working in the industry by identifying financial reporting and auditing issues within the industry for which guidance from standard

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setting bodies is needed and working with appropriate bodies having authority over such standards in finding resolutions to the issues. For more information about the activities of the Not-for-Profit Entities Expert Panel, visit the panel's Internet page at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/COMMUNITY/NOTFORPROFIT/Pages/NotforProfit.aspx.

Industry Websites

.121 The Internet covers a vast amount of information that may be valuable to auditors of entities subject to *Government Auditing Standards* or Circular A-133 audits, including current industry trends and developments. Some of the more relevant sites are shown in the appendix, "Additional Internet Resources," of this alert.

.122

Appendix—Additional Internet Resources

Here are some useful websites that may provide valuable information to accountants.

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Professional Issues Task Force	Summaries of practice issues that appear to present concerns for practitioners and disseminate information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestGuidance/Pages/PITFPracticeAlerts.aspx
Catalog of Federal Domestic Assistance (CFDA)	Electronic searchable version of the CFDA, which may be useful for identifying or verifying CFDA numbers	www.cfda.gov
Department of Education: Office of Inspector General Non-Federal Audit Team	Provides sources, including various audit guides, to assist in the conduct and understanding of single audits and audits of student financial aid	www2.ed.gov/about/offices/list/oig/nonfed/nfteam.html
Department of Housing and Urban Development (HUD): Office of Inspector General	Among the items found on this website is the Consolidated Audit Guide for Audits of HUD Programs	www.hudoig.gov
Federal Audit Clearinghouse (FAC)	Website used for submission of data collection form. It contains various versions of the data collection form (Form SF-SAC)	http://harvester.census.gov/fac/
Federal Funding Accountability and Transparency Act (FFATA)	Information related to the Transparency Act and its related reporting	http://ffata.org/ffata/
FFATA Subaward Reporting System (FSRS)	Report submission website	www.fsrs.gov
The Federal Reserve Board	Source of key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
Government Accountability Office (GAO)	Policy and guidance materials and reports on federal agency major rules	www.gao.gov
Governmental Accounting Standards Board (GASB)	Summaries of recent accounting pronouncements and other GASB activities	www.gasb.org

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Website Name	*Content*	*Website*
Governmental Audit Quality Center	A membership center for firms and state audit organizations providing information and resources to those performing governmental audits	www.aicpa.org/GAQC
Government Printing Office Access	Includes a comprehensive list of available official federal resources (and related links) and is the official online bookstore for government publications	www.gpoaccess.gov
IGnet	Includes electronic versions of the audit review guidelines that the federal inspectors general use in performing reviews of selected single audits	www.ignet.gov/
Office of Management and Budget (OMB)	Includes information on the federal budget, the president's management agenda, regulatory and legislative information, and OMB circulars. Also includes guidance related to Recovery Act programs and the accountability of Recovery Act funding	www.whitehouse.gov/omb/ OMB circulars: www.whitehouse.gov/omb/circulars/ Recovery Act guidance: www.whitehouse.gov/omb/recovery_default
Private Company Financial Reporting Committee	Information on the initiative to further improve FASB's standard-setting process to consider needs of private companies and their constituents of financial reporting	www.pcfr.org
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB and other matters	www.pcaob.org
Recovery.gov and Recovery Accountability and Transparency Board (RATB)	User-friendly tool maintained by the RATB to track Recovery Act spending and projects, including how and where the funds are spent	www.recovery.gov
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov
USAspending.gov	Searchable database with information on government contract, grant, and other award data	www.usaspending.gov

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AAM Section 8240

Independence and Ethics Developments—2010/11

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING

Notice to Readers

This Audit Risk Alert replaces *Independence and Ethics Developments—2009*.

This Audit Risk Alert is designed to provide illustrative information with respect to the subject matter covered. It does not establish standards or preferred practices. The material has not been considered or acted upon by senior technical committees or the AICPA board of directors and does not represent an official opinion or position of the AICPA. It is provided with the understanding that the author and publisher are not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional person should be sought. The author and publisher make no representations, warranties, or guarantees about and assume no responsibility for the content or application of the material contained herein and expressly disclaim all liability for any damages arising out of the use of, reference to, or reliance on such material.

Recognition

Our special thanks to Catherine Allen, CPA, who developed and wrote this Audit Risk Alert.

The AICPA gratefully appreciates the invaluable assistance Dennis W. Ridge, Jr., CPA, provided in creating this publication.

The AICPA gratefully acknowledges Ellen Goria, CPA (NY), of the AICPA Professional Ethics Division for her essential contributions in creating this publication.

Feedback

The Audit Risk Alert *Independence and Ethics Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert also would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.

How This Alert Helps You

.01 This Audit Risk Alert (alert) informs you of recent developments in the important areas of independence and ethics for accountants. This alert helps you understand your independence requirements under the AICPA Code of Professional Conduct (code) and, if applicable, certain other rule making and standard setting bodies. We present a section entitled "Digest of the AICPA Independence Rules" in plain English at the end of this alert so you can understand and apply the independence rules with greater confidence.

Current Practice Environment

.02 Members of the accounting profession are held to very high ethical standards because they are entrusted with so much. Investors, lenders, regulators, analysts, and others place their faith and confidence in the integrity and objectivity of accountants, auditors, and other members of the profession every day.

.03 Although signs of economic recovery have been reported in 2010, by April, dire fiscal troubles in Greece, and later, other countries in the European Union (E.U.), were revealed, causing concerns about a much-needed bailout to keep Greece from defaulting on its debts. Such concerns, particularly the fate of the Euro currency, the E.U. economies, and their impact on the American economy, caused world markets to gyrate and gold prices to skyrocket as investors pursued perceived "safe havens" for their money. At home, consumers worried about the sustainability of the recovery and continued weakness in the labor market, causing consumer confidence in the economy to plummet by mid-year.

.04 Because accountants create the books and records that tell the company's financial story, and auditors issue opinions on whether those financial statements are materially correct, the foundering economic recovery will likely continue to exert incentives and pressures to maintain profits and performance, sometimes at the expense of ethical conduct.

.05 As always, accounting professionals must continually be aware of these pressures and act with skepticism and diligence. Auditors should recognize that changing economics could sway professionals to do things that, in normal times, they would never consider doing. Practitioners also should be mindful of allotting sufficient resources to engagements so that due professional care is exercised, and all services are carried out in accordance with the applicable professional standards.

AICPA Independence and Ethics Developments

New and Revised Ethics Standards

Revised Independence Standards: Participation of a Covered Member's Immediate Family in Benefit Plans and Related Provisions

.06 In May 2010, the AICPA Professional Ethics Executive Committee (PEEC) released revised and clarified independence rules in the code affecting the following:

a. Interpretation No. 101-1, "Interpretation of Rule 101," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .02), as it applies to covered members formerly associated with an attest client and participation of a covered member's immediate family in an employer's benefit plan. The revisions to Interpretation No. 101-1 are effective June 1, 2011, with earlier application allowed.

b. Ethics Ruling No. 107, "Participation in Health and Welfare Plan Sponsored by Client," of ET section 100, *Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .214–.215). The revisions to Ethics Ruling No. 107 were effective May 31, 2010.

c. Interpretation No. 101-15, "Financial Relationships," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .17). The revisions to Interpretation No. 101-15 were effective May 31, 2010.

.07 Changes to preceding items (*a*) and (*b*) were editorial in nature and aligned those standards to substantive changes in Interpretation No. 101-1, which mainly provided additional guidance regarding the independence of a covered member whose immediate family (spouse, spousal equivalent, or dependent) participated in an employer's benefit plan. The new standard describes certain safeguards that must be met for independence to be maintained, including when the covered member's immediate family member holds an investment in the attest client via the plan.

.08 The basic rule allows the immediate family of a covered member to, as a result of his or her permitted employment, participate in the attest client's benefit plan (other than the three types of plans described in paragraph .10) providing that all of the following exist:

- The plan is offered to others in comparable employment positions.
- The immediate family member is not involved in governance for the plan.

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- The immediate family member is unable to supervise or participate in the plan's investment decisions and options.

.09 In addition, the immediate family member of a covered member may hold a direct or material, indirect financial interest in the attest client as a plan participant if both of the following are present:

- The financial interest is due to the unavoidable consequence of participation in the plan (that is, if an investment other than in the attest client is available, that option must be taken).
- The covered member is not a member of the attest team or in a position to influence the attest engagement.

.10 Participation in the following plans requires certain additional safeguards:

- Share-based compensation arrangements that result in rights to acquire shares in the attest client, for example, employee stock option or restricted stock plans
- Share-based compensation arrangements that depend on the appreciation of the underlying shares of the attest client's stock, for example, stock appreciation or phantom stock plans
- "Nonqualified" deferred compensation plans

.11 For further information, see www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/DownloadableDocuments/2009September4ExposureDraftFinalAdoptedProposals.doc.

New Independence Standard: Network Firms

.12 In July 2010, the PEEC released a new independence standard and related definitions in the code that address practice by accounting firms within certain types of membership associations, that is, networks.

.13 New Interpretation No. 101-17, "Network Firms," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .19), states that a network firm is required to be independent of financial statement audit and review clients of other network firms if the use of the audit or review report for the client is not restricted as defined by professional standards. For all other attest clients, practitioners should consider any known threats to independence that may be created by network firm interests and relationships. If those threats are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. The independence requirements apply to any entity within the network that meets the definition of a *network firm* as defined in paragraph .22 of ET section 92, *Definitions* (AICPA, *Professional Standards*, vol. 2). Practitioners should consult ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*, vol. 2), for further guidance on analyzing threats and applying appropriate safeguards.

.14 Two criteria signify the existence of a network firm relationship and, therefore, trigger the additional independence requirements. The first criterion is that the firms in the association cooperate for the purpose of enhancing their abilities to provide professional services. The second criterion would be satisfied if any one of the following situations exists:

- Members of an association of firms (member firms) or entities controlled by member firms share a common brand name or common initials as part of the firm's name.
- Member firms are under common control (as defined under U.S. generally accepted accounting principles [GAAP]) with other member firms through ownership, management, contractual, or other means.
- Member firms share profits or costs.
- Member firms share a common business strategy, which involves ongoing collaboration among the firms. Firms are held accountable for implementing the strategy and for their performance pursuant to that strategy.

- Member firms share a significant portion of professional resources (for example, technical departments, technical manuals, training systems).
- Member firms must adhere to common quality control policies and procedures, which are monitored by the association.

.15 If a member firm solely refers work to, or receives referrals from, other member firms in an association and does not meet any of the preceding criteria discussed previously in paragraph .14, then the firm would not be considered to be operating within a network.

.16 The standard provides several exceptions and clarifications for the preceding criteria. See the following URLs for additional information:

- Additional information on Interpretation No. 101-17 can be found at www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_101.aspx#10117.
- The definitions of *network* (paragraph .21 of ET section 92) and *network firm* (paragraph .22 of ET section 92) can be found at www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_92.aspx.
- Implementation guidance can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Ethics%20Division%20Network%20Firm%20Implementation%20Guidance.docx.

Revisions to Statements on Standards for Tax Services

.17 The AICPA Tax Executive Committee has issued revised Statements on Standards for Tax Services (SSTSs), which are enforceable rules of conduct under Rule 201, *General Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 201), and Rule 202, *Compliance With Standards* (AICPA, *Professional Standards*, vol. 2, ET sec. 202), of the AICPA code. The final revisions to the SSTSs clarify and streamline the guidance and address changes in federal and state tax laws. The revised standards became effective on January 1, 2010.

.18 The final standards are available at www.aicpa.org/InterestAreas/Tax/Resources/StandardsEthics/StatementsonStandardsforTaxServices/DownloadableDocuments/SSTS,%20Effective%20January%201,%202010.pdf.

Accounting and Review Services Committee

New Standard for Compilation and Review Engagements Permits Disclosure of the Reason(s) for Independence Impairment in a Compilation Report

.19 Statement on Standards for Accounting and Review Services (SSARS) No. 19, *Compilation and Review Engagements*, was issued in December 2009. Among other changes, the new standard permits members the option of disclosing the reason (or reasons, if there is more than one) for an independence impairment in the accountant's compilation report. Previously, accountants were prohibited from disclosing the reason (or reasons, if there were more than one) for an independence impairment in the accountant's compilation report.

.20 The trio of proposed standards that eventually became SSARS No. 19 included a proposal that would have permitted a member to perform a review engagement when independence was impaired due to the performance of certain nonattest services on behalf of management to design or operate any aspect of internal control over financial reporting (described in the three proposed standards as internal control services). That element of the three proposed standards was not adopted in SSARS No. 19. Due to significant interest in the topic, the Accounting and Review Services Committee (ARSC) decided to defer adopting this element of the proposed standards, pending additional meetings with key stakeholders to further discuss certain issues, for example, to better understand issues smaller firms face in trying to serve their clients and why some stakeholders opposed this aspect of the trio of proposed standards.

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.21 Most provisions of SSARS No. 19 will not be effective until periods ending on or after December 15, 2010; however, ARSC decided to permit accountants to disclose the reason(s) for an independence impairment in the compilation report as soon as practicable.

.22 See www.aicpa.org/download/auditstd/SSARS_19_White_Paper.pdf for a question and answer document that the staff of the AICPA's Audit and Attest Standards Team developed to provide additional guidance on the new compilation reporting option.

New Ethics Guidance

New Independence Guidance on Nonattest Services

.23 In February 2010, the staff of the AICPA Professional Ethics Division issued three new frequently asked questions (FAQs) on Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05). The FAQs, which are not authoritative, bring the total number of FAQs on the topic to 48 and address such issues as documentation of the engagement; performance of management functions; and, among others, controllership, tax, and valuation services. Keep in mind 2 important caveats when considering this guidance:

a. Compliance with all applicable provisions of Interpretation No. 101-3, for example, the "General Requirements," is presumed.

b. The FAQs address only the application of AICPA independence rules to the circumstances. If other regulatory requirements apply, those other rules must be applied in addition to the AICPA rules.

.24 The new FAQs address two types of services that attest clients may request from their audit firms in connection with their consideration, planning, or implementation of changes to their financial reporting systems or processes: training and project management assistance. Two examples discussed in the FAQs are transitioning the client's financial reporting system from U.S. GAAP to International Financial Reporting Standards (IFRSs) and implementing eXtensible Business Reporting Language (XBRL) to the client's financial reporting system.

.25 Under the new guidance, a firm may provide general training to the client's staff on a subject matter (such as IFRSs), or more specific training on the client's particular circumstances, if staff already has a basic knowledge of the subject. The member should not perform management activities, including for example, supervising the client's staff in their operation of the new system or process. In terms of project management, the member may assist the client by providing feedback and guidance on issues relevant to the project, commenting on assumptions, or supplying information that management uses to conduct its analysis. As always, members should ensure the client designates an individual who is capable of making, and will indeed make, all management decisions related to the project.

.26 Additional information on the FAQs may be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.

Professional Ethics Division Enforcement Actions

.27 The AICPA Professional Ethics Division enforces members' compliance with the code via the Joint Ethics Enforcement Program (JEEP), which is conducted in concert with the state CPA societies. The following are examples of common disciplinary findings and the rules in the code to which they relate:

- Ethics Rule 201
  - — An audit partner in a CPA firm did not have the professional competence to properly perform the role of engagement partner because the audit partner had not received adequate continuing professional education.
  - — An auditor failed to exercise due professional care during the client acceptance process by failing to perform an appropriate risk assessment.

- Ethics Rule 202
  - An auditor failed to make appropriate inquiries concerning the professional reputation and independence of another auditor on whose procedures he or she relied.
  - An auditor failed to make required communication with the predecessor auditor prior to accepting a new audit engagement.
  - An auditor failed to obtain sufficient, competent evidence.
  - An auditor failed to document procedures performed.
- Ethics Rule 203, *Accounting Principles* (AICPA, *Professional Standards*, vol. 2, ET sec. 203 par. .01)
  - The financial statements prepared by a member in industry did not include appropriate disclosures related to his or her employer's stock option plan.
  - The financial statements prepared by a member in industry failed to disclose in the financial statements the significant components of income tax expense of his or her company.
  - A member prepared financial statements that incorrectly used a method of accounting for uncollectible accounts, that is, did not comply with GAAP.

.28 The following matters investigated via the JEEP also resulted in violations of the code by members:

- A member paid a referral fee to a CPA firm, which was then paid to an officer of the client without disclosing all of the relevant details. (A violation of Interpretation No. 102-2, "Conflicts of Interest," under Rule 102, *Integrity and Objectivity* [AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .03])
- A member violated a federal regulator's independence rules by entering into a fee-sharing agreement with the officer of the client. (A violation of Interpretation No. 501-5, "Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies in Performing Attest or Similar Services," under Rule 501, *Acts Discreditable* [AICPA, *Professional Standards*, vol. 2, ET sec. 501 par. .06])
- A member auditing a benefit plan failed to gain an understanding of the internal controls that relate to the payroll and personnel functions of the plan sponsors. (A violation of Ethics Rule 202)
- A member auditing a benefit plan relied on actuarial information without considering the professional qualifications, reputation, and independence of the actuary. (A violation of Ethics Rule 201[B]), "Due Professional Care")
- An auditor created journal entries and coded deposits and disbursements for reporting in a client's general ledger without obtaining client approval, that is, audited his or her own work. (A violation of Interpretation No. 101-3)
- A member in industry failed to promptly investigate numerous suspicious transactions despite his or her concerns over their accounting treatment and failed to timely present these concerns to the company's governance bodies. (Violations of Interpretation No. 102-4, "Subordination of Judgment by a Member," under Rule 102 [AICPA, *Professional Standards*, vol. 2, ET sec. 102 par. .05])
- A member auditing a government agency subject to Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* requirements did not accurately identify and test all major programs in accordance with the OMB guidelines. (A violation of Interpretation No. 501-5)

Compliance Reminder Regarding Other Authoritative Bodies

.29 The independence and ethics rules under the code apply to all members of the AICPA. However, other rule-making and standard-setting bodies, such as the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), the Government Accountability Office (GAO), the U.S. Department of Labor (DOL), the IRS, the U.S. Department of the Treasury, banking and insurance agencies, state boards of accountancy, and state CPA societies also have independence or other ethics rules with which

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members must comply, if applicable, in addition to the AICPA rules. The rules of some of these other bodies are discussed briefly in this alert. You should refer to the original text of each organization's rules for full guidance.

SEC Independence Rules

.30 Rule 2-01, "Qualifications of Accountants," of Regulation S-X sets forth the SEC's independence rules. The rule is designed to ensure that auditors are qualified and independent of their audit clients both in fact and appearance. Accordingly, the rule establishes restrictions on financial, employment, and business relationships between an accountant and an audit client and the provisions of certain nonaudit services to an audit client.

.31 Rule 2-01 begins with a general standard of auditor independence, which states the following:

> The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission (Rule 2-01[b]).

.32 The succeeding paragraphs reflect the application of the general standard to particular circumstances. In addition, the second preliminary note to Rule 2-01 states the following:

> The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in Rule 2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client.

.33 The rule indicates that the preceding factors are general guidance only, and their application may depend on particular facts and circumstances. Thus, Rule 2-01 also provides that

> ... in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the rule.

Prohibited Nonaudit Services

.34 Practitioners are reminded that, with very limited exceptions, several nonaudit services may not be provided to audit clients and their affiliates during the audit and professional engagement period, including the following:

- Bookkeeping services (including payroll)
- Valuation, appraisal, or actuarial services
- Financial information systems design or implementation
- Human resource services
- Any service involving the performance of management functions (for example, decision making, supervisory, or ongoing monitoring functions)
- Legal services

- Expert services
- Internal audit outsourcing
- Broker-dealer, investment advisory, or investment banking services
- Certain tax services (that is, services in which a firm supports an aggressive or confidential transaction and personal tax services provided to persons in financial reporting oversight roles)

.35 Practitioners should examine all nonaudit services to be performed in light of the SEC general standard and the four guiding principles described in the preceding paragraphs .30–.33. Increased competition and pressure to maintain revenues by providing additional nonaudit services to audit clients continue to be intense in light of the slow and uneven economic recovery. Nevertheless, maintaining independence must take precedence over commercial concerns.

New Custody Rules Affect Auditors

.36 The SEC adopted amendments to the custody and recordkeeping rules under the Investment Advisers Act of 1940 (Investment Advisers Act) and related forms that may require a company to be audited by an accounting firm registered with the PCAOB and subject to periodic inspections. For example, additional safeguards are required when a registered investment adviser has custody of a client's funds or securities.

.37 Under the revised rules of the Investment Advisers Act, an accounting firm must be registered with, and subject to regular inspection by, the PCAOB if it is engaged to

- perform an annual audit of a pooled investment vehicle in accordance with Rule 206(4)-2(b)(4);
- perform an annual surprise examination of an adviser that maintains client assets with a qualified custodian that is the adviser (or a related person of the adviser) in accordance with Rule 206(4)-2(a)(4); or
- prepare an internal control report in accordance with Rule 206(4)-2(a)(6).

.38 The new rules went into effect on March 12, 2010.

.39 To read *Staff Responses to Questions About the Custody Rule*, see www.sec.gov/divisions/investment/custody_faq_030510.htm.

Initial Public Offering

.40 If your privately held audit client files an initial public offering (IPO) with the SEC, your firm is required to be independent under the SEC's rules for all periods included in the filing (that is, the audit period). Prior to the IPO, the firm may have provided services or had business or fee relationships with the company that did not comply with the SEC independence rules. Even though the firm was not subject to SEC rules at the time the nonaudit services were provided or the business or fee relationship existed, the firm will be held to the SEC rules for those prior audit periods. Remember, if your client intends to file an IPO and wants your firm to continue as its auditor, you must comply with SEC independence rules for all years covered by the audit opinion included in the IPO. This includes not only nonaudit services and business and fee relationships that your firm had with the client in recent years but also extends to your firm's associated entities and affiliates of your audit client (such as subsidiaries and companies under common control with your audit client).

PCAOB Rules Regarding Independence and Ethics

.41 The PCAOB has the authority to establish ethics and independence standards, in accordance with Section 103(a), "Auditing, Quality Control, and Ethics Standards," and Section 103(b), "Independence Standards and Rules," of the Sarbanes-Oxley Act of 2002 (SOX). Firms that issue audit reports on public companies are required to register with the PCAOB. Failure to do so may result in disciplinary action.

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Additionally, any registered public accounting firm or person associated with such a firm that fails to adhere to applicable PCAOB standards may be the subject of a PCAOB disciplinary proceeding, in accordance with Section 105, "Investigations and Disciplinary Proceedings," of SOX. Under Section 107, "Commission Oversight of the Board," of SOX, PCAOB rules become effective only after they are approved by the SEC. The PCAOB independence and ethics rules include the following:

- PCAOB Rule 3100, *Compliance with Auditing and Related Professional Practice Standards* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board).
- PCAOB Rule 3500T, *Interim Ethics Standards* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board).
- PCAOB Rule 3600T, *Interim Independence Standards* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board).
- PCAOB Rules 3501–3526 describe the independence and ethics standards promulgated by the board and approved by the SEC since the board's inception.

.42 The full text of these rules can be found at http://pcaobus.org/Standards/Pages/default.aspx.

.43 PCAOB Rule 3100 generally requires all registered public accounting firms to adhere to the PCAOB's auditing and related professional practice standards, which encompass auditing, attestation, quality control, ethics, and independence standards, in connection with the preparation or issuance of any audit report for an issuer and in their auditing and related attestation practices. This rule also requires registered public accounting firms and their associated persons to comply with all applicable standards. Accordingly, if the PCAOB's standards do not apply to an engagement or other activity of the firm, PCAOB Rule 3100, by its own terms, does not apply to that engagement or activity.

Interim Ethics Standards

.44 PCAOB Rule 3500T designates the provisions of the code on integrity and objectivity as interim ethics standards. Accordingly, in preparing or issuing an audit report, a registered public accounting firm and its associated persons should comply with ethics standards as described in Ethics Rule 102 and interpretations and rulings thereunder in existence as of April 16, 2003, to the extent not superseded or amended by the PCAOB.

Interim Independence Standards

.45 PCAOB Rule 3600T designates the provisions of the code regarding independence and existing standards and interpretations of the Independence Standards Board (ISB) as interim independence standards. This rule states that, in connection with the preparation or issuance of any audit report, a registered public accounting firm and its associated persons shall comply with the following independence standards, to the extent not superseded or amended by the PCAOB:

- Ethics Rule 101 and interpretations and rulings thereunder in existence on April 16, 2003
- ISB Standard No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities* (AICPA, *PCAOB Standards and Related Rules*, Standards)
- ISB Standard No. 3, *Employment with Audit Clients* (AICPA, *PCAOB Standards and Related Rules*, Standards)
- ISB Interpretation No. 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)* (AICPA, *PCAOB Standards and Related Rules*, Standards)

.46 To the extent that the SEC's rules are more or less restrictive than the PCAOB's interim independence standards, registered public accounting firms must comply with the more restrictive requirements.

Communications With Audit Committees Before Client Acceptance

.47 PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), requires auditors to communicate with the audit committee of a prospective audit client before accepting the engagement and on an annual basis. Under that rule, the auditor must describe in writing to the audit committee all relationships between the auditor and the client (including affiliates of both) that reasonably could be thought to bear on independence, discuss these matters with the audit committee, and document the substance of that discussion.

PCAOB Oversight of Broker-Dealer Audits Expanded Under New Financial Stability Act

.48 Since 2009, auditors of broker dealers have been required to register with the PCAOB, regardless of whether or not those clients are "issuers" (in February 2009, the PCAOB staff published guidance for firms that addresses, among other things, the registration process, periodic reporting, and annual fee requirements). However, until the Restoring American Financial Stability Act of 2010 was signed into law in July 2010, the PCAOB lacked the authority to determine, inspect for compliance with, or enforce the standards applicable to audits of broker-dealers that are nonissuers. This act gives full oversight authority over broker-dealer audits to the PCAOB, which will be developing or amending auditing and related professional practice standards (including independence and ethics), as needed, to address broker-dealer audits. In July 2010, the PCAOB sought input on this topic from its Standing Advisory Group. Refer to http://pcaobus.org/News/Events/Pages/07152010_SAGMeeting.aspx for additional information.

GAO Independence Standard

.49 CPAs, non-CPAs, government financial auditors, and performance auditors who audit federal, state, and local governments, as well as not-for-profit and for-profit recipients of federal (and some state) grant and loan assistance, should be familiar with the ethics and independence requirements of *Government Auditing Standards* (GAS [also referred to as the Yellow Book]).

.50 The Single Audit Act of 1984 requires state and local governments and nonprofit entities to be audited under GAS if they spend $500,000 or more of federal awards in a given fiscal year. Federal awards include federal financial assistance (such as grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance) and cost reimbursement contracts. OMB Circular A-133 provides the guidelines and policies for performing single audits under the Single Audit Act of 1984.

.51 Funds obtained as a result of the 2009 American Recovery and Reinvestment Act may cause an entity to exceed the $500,000 threshold, requiring it to obtain a single audit for the first time. This subjects the entity to additional regulations, including those for independence, of which the auditor and the auditee should be prepared to address. (Note: GAO independence requirements for nonaudit services are, in some instances, stricter than AICPA standards.) To be proactive and address any issues on a timely basis, auditors should hold discussions with their clients to determine whether additional reporting requirements will apply in the coming year. For further information, see www.journalofaccountancy.com/Issues/2010/Jun/20092145.htm.

.52 Certain companies (issuers) subject to the Securities Exchange Act of 1934 may have an audit conducted in accordance with standards issued by the PCAOB, as required by SOX, the SEC, and the Comptroller General of the United States, as contained in GAS (for example, a bank that participates in federally sponsored loan programs). For such entities, auditors must satisfy all three sets of standards in conducting their work.

.53 The July 2007 Yellow Book is effective for (*a*) financial statement audits and attest engagements for periods beginning on or after January 1, 2008, and (*b*) performance audits beginning on or after January 1, 2008. The distinction between (*a*) and (*b*) is that (*a*) applies to the period under audit, whereas (*b*) applies to the engagement start date. Thus, an audit of financial statements for the period ended December 31, 2007, would be subject to the old (2003) Yellow Book, even though the audit is performed in 2008, whereas a performance audit would be subject to the new Yellow Book, regardless of the period under audit.

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.54 Chapters 2–3 of the July 2007 Yellow Book address professional ethics and independence, respectively. The GAO independence rules are, in some cases, very similar to the AICPA independence rules; however, in other cases (for example, rules applicable to the performance of nonaudit services), the GAO independence rules tend to be more restrictive.

.55 To perform nonaudit services under the GAO independence rules, the auditor must observe two overarching principles: (*a*) firms must not provide nonaudit services that involve performing management functions or making management decisions, and (*b*) firms must not audit their own work or provide nonaudit services in situations in which the nonaudit services are significant or material to the subject matter of the audit.

.56 The Yellow Book categorizes nonaudit services as follows:

- *Nonaudit services that do not impair independence and do not require compliance with the supplemental safeguards.* Examples of these services include services that are considered to be routine advice because they typically are performed in conjunction with the audit (for example, advice on the implementation of internal controls or new accounting standards).
- *Nonaudit services that would not impair independence provided the auditor complies with the supplemental safeguards.* Examples of these services include certain limited bookkeeping, IT, or human resource assistance or preparation of routine tax filings.
- *Nonaudit services that impair independence; compliance with supplemental safeguards will not overcome this impairment.* Examples of these services include posting entries to the general ledger, processing payroll that is material to the financial statements, or designing a financial reporting system. (Note: By their nature, these services violate one or both of the overarching principles discussed in the Yellow Book.)

.57 On August 23, 2010, the GAO released an exposure draft of the new Yellow Book. Changes to the independence standards (as described in the draft) are described in paragraphs .58–.59.

.58 A conceptual framework for independence was added to provide a means for auditors to assess auditor independence in light of the unique circumstances that may apply to these determinations and are not expressly prohibited (paragraphs 3.02–.52). The proposed conceptual framework achieves further harmonization with AICPA and international standards, with the following additional considerations for government audits.

- A conceptual framework for making independence determinations based on facts and circumstances that are often unique to specific audit environments (paragraphs 3.06–.26)
- Guidance for auditors considering independence issues as they relate to audit organizations that are structurally located within the governments they audit (paragraphs 3.27–.42)
- Independence requirements when performing nonaudit services, including indication of specific nonaudit services that would impair independence (paragraphs 3.43–.51)
- Guidance on documentation necessary to support adequate consideration of auditor independence (paragraph 3.52)

.59 When issued in final form, the 2011 revision will supersede the July 2007 revision of the standards and the guidance provided in *Government Auditing Standards: Answers to Independence Standard Questions* (GAO-02-870G). The effective date for the 2011 revision of the Yellow Book will be established when the standards are issued in final form. Comments on the draft Yellow Book are due November 22, 2010. For up-to-date information on the Yellow Book, see www.gao.gov/govaud/ybk01.htm.

Internal Revenue Code

Disclosure or Use of Taxpayer Information

.60 Internal Revenue Code (IRC) regulations issued in 2009 apply to the disclosure or use of tax return information. In many cases, these requirements exceed those of Rule 301, *Confidential Client Information* (AICPA, *Professional Standards*, vol. 2, ET sec.301). For example, *information*, which is broadly defined in the regulations, includes a client's name or e-mail address. Under IRC Section 7216, tax return preparers who knowingly or recklessly make unauthorized disclosures or use of information furnished to them in connection with the preparation of an income tax return are subject to criminal penalties (that is, a fine of $1,000 or imprisonment for 1 year [or both] per violation). IRC Section 6713, the companion civil provision, carries similar requirements.

.61 Temporary regulations proposed in January 2010 provide limited exceptions to the 2009 rule, which generally prohibits practitioners from disclosing or using taxpayer information without explicit, written permission from the client. For example, preparers may disclose information about clients without permission when selling their tax practices or conducting client conflict-of-interest checks. Revenue Ruling No. 2010-4 also clarifies that a preparer may disclose client names and mail or e-mail addresses to a third-party provider, who creates, publishes, and distributes newsletters or bulletins to those clients.

.62 For further details, see Revenue Ruling No. 2010-4 and Revenue Ruling No. 2010-5.

.63 The AICPA Tax Center provides helpful tools and resources at www.aicpa.org/INTERESTAREAS/TAX/RESOURCES/Pages/default.aspx.

Proposed Revisions to U.S. Treasury Department Circular No. 230

.64 On August 19, 2010, the IRS proposed revisions to regulations governing practice of attorneys, CPAs, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and appraisers before the IRS. The proposed regulations modify the general standards of practice before the IRS and the standards with respect to preparing tax returns. The document also

- withdraws the proposed amendments to section 10.34, "Standards with respect to tax returns and documents, affidavits and other papers," of U.S. Treasury Department Circular No. 230, *Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, and Appraisers before the Internal Revenue Service* (Circular No. 230), published in the Federal Register on September 26, 2007, and more closely aligns section 10.34 of Circular No. 230 with the penalty provisions of IRC Section 6694, "Understatement of taxpayer's liability by tax return preparer," although minor differences would continue to exist.
- provides new rules governing the oversight of tax return preparers permitting practice by an additional category of individuals, that is, *registered tax return preparers*. Registered tax return preparers may only prepare, or assist in the preparation of, all or substantially all of a tax return or claim for refund that is commensurate with the level of competence that the registered tax return preparer has demonstrated by written examination. This new category of preparers could include non-CPAs employed in CPA firms who work on tax returns but do not sign as preparers.
- revises section 10.30 of Circular 230 regarding solicitation, section 10.36 of Circular 230 regarding procedures to ensure compliance, and section 10.51 of Circular 230 regarding incompetence and disreputable conduct.

Comments on the proposed changes were due October 7, 2010. The proposal is available at www.irs.gov/pub/irs-utl/2010-20850_pi.pdf.

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Federal Deposit Insurance Corporation

Applicability of Independence Standards to Audits of Insured Depository Institutions

.65 Depending upon the insured depository institution (bank or financial institution) audit client, an external auditor is subject to the independence standards issued by one or more of the following standard-setters: the AICPA, the SEC, and the PCAOB. For nonpublic financial institutions[1] that are not required to have annual independent audits pursuant to either Part 363[2] of the Federal Deposit Insurance Corporation's (FDIC's) regulations or Section 562.4[3] of the Office of Thrift Supervision's (OTS's) regulations, the external auditor must comply with the AICPA's independence standards; the financial institution's external auditor is not required to comply with the independence standards of the SEC and the PCAOB.

.66 In contrast, for financial institutions subject to the audit requirements either in Part 363 of the FDIC's regulations or in Section 562.4 of the OTS's regulations, the external auditor should be in compliance with the independence standards of the AICPA, the SEC, and the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, the independent public accountant must comply with the more restrictive rule.

.67 For financial institutions and bank holding companies that are public companies,[4] regardless of size, the external auditor should be in compliance with the SEC's and the PCAOB's independence standards as well as the AICPA's independence standards.

.68 The following table illustrates the applicability of the AICPA, SEC, and PCAOB independence standards:

Applicability of Auditor Independence Standards	AICPA Independence Standards	Securities and Exchange Commission Independence Standards	Public Company Accounting Oversight Board Independence Standards
Scenario 1 Nonpublic institutions **not** subject to Part 363 of the Federal Deposit Insurance Corporation's (FDIC's) regulations or Section 562.4 of the Office of Thrift Supervision's (OTS's) regulations	Yes	No	No
Scenario 2 Public and nonpublic institutions subject to Part 363 of the FDIC's regulations or Section 562.4 of the OTS's regulations	Yes	Yes	Yes
Scenario 3 Institutions and holding companies that are public companies (regardless of size)	Yes	Yes	Yes

[1] *Nonpublic financial institutions* are companies that are not, or whose parent companies are not, subject to the reporting requirements of the Securities Exchange Act of 1934.

[2] Part 363 of the Federal Deposit Insurance Corporation's (FDIC's) regulations implements Section 36 of the Federal Deposit Insurance Act (FDI Act). Part 363 and Section 36 of the FDI Act can be found at www.fdic.gov/regulations/laws/rules/2000-8500.html and www.fdic.gov/regulations/laws/rules/1000-3800.html#fdic1000sec.36, respectively. Also, the link to the FDIC's Financial Institution Letter 33-3009, which includes the Final Rule regarding the most recent amendments to Part 363, is www.fdic.gov/news/news/financial/2009/fil09033.html.

[3] Section 562.4 of the Office of Thrift Supervision's regulations can be found at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=6e215162e955bfc175aab8c0302f5f8a&rgn=div5&view=text&node=12:5.0.1.1.32&idno=12#12:5.0.1.1.32.0.42.3

[4] *Public companies* are companies, or subsidiaries of companies, that are subject to the reporting requirements of the Securities Exchange Act of 1934.

Limitations of Liability Provisions and Acts Discreditable

.69 On February 3, 2006, the federal banking agencies, together with the National Credit Union Administration, issued an Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters.[5] The Interagency Advisory applies to engagement letters executed on or after February 9, 2006, and provides that the inclusion of indemnification and limitation of liability provisions in external audit engagement letters will generally be considered an unsafe and unsound practice. Appendix A of the Interagency Advisory contains examples of unsafe and unsound limitation of liability provisions. The Interagency Advisory applies to all audits of financial institutions, regardless of the size of the financial institution, whether the financial institution is public or not, and whether the audits are required or voluntary.

.70 In July 2008, the AICPA's PEEC adopted Interpretation No. 501-8,[6] "Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Provisions in Connection With Audit and Other Attest Services", under Rule 501 (AICPA, *Professional Standards*, vol. 2. ET sec. 501 par. .09). The interpretation was published in the July 2008 *Journal of Accountancy*, with an effective date of July 31, 2008. Regarding financial institution audits, the interpretation means that including any of the prohibited limitation of liability provisions set forth in the Interagency Advisory in external audit engagement letters executed after July 31, 2008, is an act discreditable to the profession and could result in AICPA members being subject to disciplinary actions.

Part 363 of the FDIC's Regulations and PCAOB Rule 3526

.71 Section 363.4(c) of the FDIC's regulations requires each insured depository institution subject to Part 363 to file with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor a copy of any written communication issued by its independent public accountant regarding matters that are required to be communicated to the institution's audit committee within 15 days after receipt.

.72 PCAOB Rule 3526[7] requires auditors to communicate with the audit committee of a prospective audit client before accepting the engagement and on an annual basis. For additional discussion of this requirement refer to paragraph .47 in this alert.

.73 Auditors of an insured depository institution subject to Part 363 of the FDIC's regulations must comply with PCAOB Rule 3526 whether or not the insured depository institution is itself a public company or is a subsidiary of a public company. Also, pursuant to Section 363.4(c) of the FDIC's regulations, the insured depository institution is required to file this written communication concerning the auditor's independence with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor.

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[5] See the February 3, 2006, Joint Press Release (www.fdic.gov/news/news/press/2006/pr06011.html), the FDIC's Financial Institution Letter 13-2006, dated February 9, 2006 (www.fdic.gov/news/news/financial/2006/fil06013.html), and the Federal Register, Volume 71, Page 6847 (www.fdic.gov/regulations/laws/federal/2006/06notice29.pdf).

[6] Interpretation No. 501-8, "Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Provisions in Connection With Audit and Other Attest Services," under Rule 501, *Acts Discreditable* (AICPA, *Professional Standards*, vol. 2. ET sec. 501 par. .09) can be found at www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_500.aspx#et_501.09.

[7] PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board) can be found at http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx#rule3526.

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On the Horizon

Proposed AICPA Ethics Interpretation

Proposed Definition of Confidential Client Information and Proposed Revision to Ethics Ruling No. 2, "Distribution of Client Information to ~~Trade Associations~~ Third Parties" of ET section 391, Ethics Rulings on Responsibilities to Clients

.74 On September 4, 2009, the PEEC proposed a new definition of *confidential client information* and revisions to an existing ethics ruling under ET section 391, *Ethics Rulings on Responsibilities to Clients* (AICPA, *Professional Standards*, vol. 2). The ruling addresses whether a member would violate Ethics Rule 301 if he or she provided client information, such as statistical information or other data that does not identify the client, to a third party without the client's consent. In the proposal, the third party would use the information for research or benchmarking purposes. The PEEC is in the process of evaluating the comments received on its proposal.

AICPA PEEC Projects

Ethics Codification Project

.75 In 2009, the AICPA launched the Ethics Codification Project to restructure and enhance its ethics literature by creating a logically structured, topical format and redrafting provisions using consistent wording conventions and styles. Like the Financial Accounting Standards Board's (FASB's) much larger initiative to create the *Accounting Standards Codification*™ (ASC) from the legacy accounting literature, the code is in need of a similar transformation. Existing in multiple locations, similar subject matters are sometimes disjointed, making it difficult for members to know for certain whether they have considered all the relevant matters. Further, some ethics guidance resides outside the code (for example, informal AICPA staff positions and basis for conclusions documents, which carry no authority but provide helpful guidance or background on the rules). The Ethics Codification Project provides an opportunity to reevaluate that guidance and determine whether to propose that some of it be made authoritative and incorporated into the codified ethics standards.

.76 The primary objective of the Ethics Codification Project is to improve the code by making it topical and easier to use. Other important goals of codification will be to retain the substance of the existing AICPA ethics standards, improve research capability via the use of technology, and enhance the clarity of the code through the use of consistent drafting conventions and styles.

Participation of a Covered Member's Immediate Family in an Employee Benefit Plan Task Force

.77 This PEEC task force concluded its work early in 2010, which resulted in revisions to an existing ethics ruling and two ethics interpretations. The revised standards are discussed further in preceding paragraphs .06–.11 under the heading "New and Revised Ethics Standards."

Inadvertent Violations of the Code

.78 A PEEC task force is considering whether the AICPA code should, under certain circumstances, provide relief to members when they inadvertently violate a rule in the code. Among other things, the task force has considered what would constitute an inadvertent violation, when matters should be brought to an audit committee's attention, and how such a provision would apply to violations of Interpretation No. 101-3. Instead of revising an existing standard or preparing a new standard, this task force is preparing a document that will be offered through the AICPA Private Companies Practice Section as a tool to assist practitioners in determining when an inadvertent violation of Interpretation No. 101-3 may have occurred.

XBRL and IFRS Task Forces

.79 These two PEEC task forces concluded their work early in 2010, which resulted in new ethics guidance. This guidance is discussed further in preceding paragraphs .23–.24 under the heading "New Ethics Guidance."

Partner Compensation and Evaluation

.80 A PEEC task force is considering the International Ethics Standards Board for Accountants (IESBA) Code provision on partner compensation and evaluation to determine whether to develop an independence standard that applies when an individual is compensated or evaluated based on the sale of nonattest services to his or her attest client.

Establishing and Maintaining Internal Control

.81 One of the PEEC's current projects deals with a possible inconsistency within Interpretation No. 101-3. Interpretation No. 101-3 provides examples of general activities that would impair a member's independence, including establishing or maintaining internal controls, including performing ongoing monitoring activities for a client. The PEEC recognizes that some practitioners perceive an inconsistency in Interpretation No. 101-3 because certain bookkeeping services and other nonattest services that are permitted under Interpretation No. 101-3 could be viewed as "maintaining internal control" for the client. For example, bookkeeping is recognized to be part of the Committee of Sponsoring Organizations of the Treadway Commission's information and communication element of internal control. Additionally, some nonattest activities, such as performing calculations (for example, tax provision; leases; last in , first out [LIFO] reserve), maintaining ledgers (for example, fixed asset ledger), performing reconciliations, and identifying adjusting journal entries have been viewed as maintaining the client's controls regardless of whether management has met the general requirements of Interpretation No. 101-3 (that is, oversees the service, reviews and approves the work, and makes all significant judgments and decisions).

.82 To address the possible inconsistency in Interpretation No. 101-3, the PEEC is considering possible clarifying revisions to Interpretation No. 101-3. The revisions would provide more descriptive language about management responsibilities, which should help members distinguish better between permissible and prohibited nonattest services. Readers are encouraged to monitor the progress of this project.

.83 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings, can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

.84 Exposure drafts issued by the PEEC can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/ExposureDrafts/Pages/ExposureDrafts.aspx.

Modified Application of Rule 101 for Certain Engagements to Issue Restricted-Use Reports Under the Statements on Standards for Attestation Engagements

.85 A PEEC task force is evaluating whether to propose expansion of Interpretation No. 11, "Modified Application of Rule 101 for Certain Engagements to Issue Restricted-Use Reports Under the Statements on Standards for Attestation Engagements," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .13), to other nonfinancial statement attestation engagements besides agreed-upon procedures engagements.

International Ethics Convergence and Monitoring

.86 As business has become increasingly global, the visibility of the International Federation of Accountants (IFAC) *Code of Ethics for Professional Accountants* (IESBA code), which is issued by IESBA, has grown. For example, a firm that audits a U.S. subsidiary of a foreign parent must confirm its compliance with the IESBA code to the parent company's auditor.

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.87 A few other examples follow:

- A local firm is part of a global accounting association that is deemed, under international standards, to be a network. All firms in the network must be independent of the other network firms' audit and review clients, in accordance with those standards. In fact, the network requires its members to meet global ethics standards on all multinational assurance engagements.
- A regional firm in southern California serves as auditor of a small Los Angeles-based software developer that acquires a company in Bangalore, India. The Indian company's significant vendors, and its lenders, expect to rely on the California firm's audit report and, thus, expect the firm to meet IESBA standards.
- A small firm's client expands its business by opening a branch office in China. Lessors, vendors, and lenders in China ask the firm to audit the client's financial information in accordance with international auditing standards, which will call for the firm to comply with IESBA ethics standards.

.88 In July 2009, the IESBA released its revised code, which clarified the language of the previous code (for example, the use of *should* versus *must*) and enhanced the overall language. Included in those revisions were substantive revisions to Section 290, *Independence—Audit and Review Engagements*, which among other things, addressed internal audit services, the impact of significant fees to an accounting firm, and contingent fees. With certain exceptions, the new IESBA code will become effective on January 1, 2011, with earlier adoption permitted. More stringent rules applicable to audits of public interest entities will become effective January 1, 2012, and transition allowances have been incorporated into the rules for auditor rotation and certain nonassurance services. (The IESBA generally defines *public interest entities* as listed entities—those whose securities are listed on a recognized stock exchange—and entities whose auditors are required by law or regulation to comply with the same independence requirements as listed entities.) The revised IESBA code can be found at http://web.ifac.org/media/publications/5/2010-handbook-of-the-code-o/2010-handbook-of-the-code-o.pdf. The board recently requested comments on its proposed strategy and work plan document. Refer to the *IESBA Strategy and Work Plan, 2010—2012* at www.ifac.org/Guidance/EXD-Details.php?EDID=0137.

.89 The IESBA has declared that it will not put forth any more proposals for a period of at least two years. This "quiet period" will allow member bodies (such as the AICPA) time to align their national codes with the new IESBA code.

.90 Since 2001, the PEEC has been converging the AICPA code with the IESBA code. As a member body of the IFAC, the AICPA agrees to have ethics standards that, at a minimum, meet the IESBA ethics standards. Therefore, the PEEC will continue to consider convergence issues as part of the Ethics Codification Project. In this context, *convergence* means the PEEC may propose changes to AICPA guidance that are less strict than guidance in the IESBA code or does not exist in the current AICPA code. However, any proposed changes to the AICPA code resulting from these efforts will follow full due process as set out in the AICPA bylaws, which includes exposure of the proposed standard to the membership and consideration of all comments at PEEC meetings that are open to the public. Convergence does not mean that the PEEC will adopt lower standards when international standards are less strict.

Current Convergence Projects

Affiliate Task Force

.91 A PEEC task force has evaluated the possible independence implications that arise when a member or the member's firm have certain interests in or relationships with an affiliate of an attest client and is drafting a proposed independence interpretation.

Members in Business and Industry

.92 A PEEC task force is evaluating part C of the IESBA code to determine whether to propose that certain guidance applicable to members in business and industry, that is, members who are not in public practice, be incorporated into the AICPA code.

Three-Year Project Agenda

.93 The AICPA Professional Ethics Division maintains a three-year project agenda on its website that lists all current and future PEEC projects. The agenda can be found at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/PEECThreeYearAgenda.docx.

Status of DOL Request for Comments on Independence Rules Pertaining to Employee Benefit Plan Audits

.94 On September 11, 2006, the DOL issued a request for information (RFI) seeking public comment on the advisability of the DOL amending the auditor independence rules for employee benefit plan audits subject to the Employee Retirement Income Security Act of 1974 (ERISA). This is the first time the DOL has considered its independence requirements since DOL Interpretive Bulletin 75-9 (29 U.S. *Code of Federal Regulations* [CFR] 2509.75-9), *Interpretive bulletin relating to guidelines on independence of accountant retained by Employee Benefit Plan*, was issued in 1975. The DOL RFI notes that the current DOL requirements conflict with AICPA and SEC independence requirements and have caused confusion among practitioners. The comment period closed on December 11, 2006. To date, the DOL has not issued a response to the feedback it received regarding its RFI.

.95 The DOL's RFI can be found at http://ebpaqc.aicpa.org/NR/rdonlyres/7EA13B14-C1AE-42EF-9FD1-B1B1353A962F/0/DOL_Auditor_Independence_RFI.pdf. The comment letters received by the DOL can be found at www.dol.gov/ebsa/regs/cmt-IndPlanAccountants.html.

Resource Central

Publications

.96 Practitioners may find the following publications useful when considering independence and ethics issues. Choose the format best for you—online or print.

- *Independence Compliance: Checklists and Tools for Complying With AICPA and GAO Independence Requirements* (product no. 006661 [paperback] or WGO-XX [online])
- *Independence Compliance: Checklists and Tools for Complying With AICPA, SEC, and PCAOB Independence Requirements* (product no. 006660 [paperback] or WSC-XX [online])
- *Independence Library featuring Independence Risk Alert and 2 Independence Practice Aids* (product no. WIL-XX [online])

Journal of Accountancy—Ethics Quizzes

.97 The *Journal of Accountancy* periodically features ethics quizzes that have been prepared by the staff of the AICPA Professional Ethics Division to assist members with applying the AICPA code. Practitioners may find the following articles useful when considering independence and ethics issues:

- "Test Your Knowledge of Professional Ethics" by Jason Evans, CPA (*Journal of Accountancy*, October 2010), featuring staff answers to FAQs regarding Interpretation No. 101-3. This article is available online at www.journalofaccountancy.com/Issues/2010/Oct/20103166.
- "Test Your Knowledge of Professional Ethics" by Jason Evans, CPA (*Journal of Accountancy*, June 2010), featuring staff answers to questions raised by members via the Ethics Hotline. This article is available online at www.journalofaccountancy.com/Issues/2010/Jun/20102778.

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AICPA Online Professional Library: Accounting and Auditing Literature

.98 The AICPA has created your core accounting and auditing library online. AICPA Online Professional Library is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC, the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, *Accounting Trends & Techniques*, and more. One option is the *AICPA Audit and Accounting Guides with FASB Accounting Standards Codification*, which contains all audit and accounting guides, all audit risk alerts, and FASB ASC in the Online Professional Library (product no. WFA-XX [online]). To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.99 The AICPA offers a number of continuing professional education (CPE) courses on ethics and independence that are valuable to CPAs working in public practice and industry, including the following:

- *Ethics for Tax Practice Professionals: Circular 230 and the SSTSs* (product no. 738703HS [CD-ROM], 158702 [online])
- *Ethics: Non-Attest Services, Integrity and Objectivity* (product no. 739417HS [CD-ROM], 159414 [online])
- *Independence* (product no. 739180HS [CD-ROM], 159180 [online])
- *Professional Ethics: 2010/2011 Update* (product no. 739432HS [CD-ROM], 159432 [online])
- *Professional Ethics: AICPA's Comprehensive Course* (product no. 738394HS [CD-ROM], 732313 [text])
- *Professional Ethics: Complying With the GAO Rules* (product no. 739441HS [CD-ROM], 159441 [online])
- *Professional Ethics for CPAs in Business & Industry* (product no. 738900HS [CD-ROM], 158900 [online])
- *Professional Ethics: Navigating the Gray Areas* (product no. 739450HS [CD-ROM], 159450 [online])
- *Real World Business Ethics for CPAs in A&A: How Will You React?* (product no. 733603 [text])
- *Real World Business Ethics for CPAs in Business & Industry: How Will You React?* (product no. 733593 [text])
- *Real World Business Ethics: How Would You React?* (product no. 731687 [text])
- *Real Word Business Ethics for Tax Practitioners: How Will You React?* (product no. 733613 [text])
- *Selected Topics in Professional Ethics* (product no. 738385HS [CD-ROM], 158385 [online])

.100 The AICPA interactive CD-ROM or online course on independence titled *Independence* teaches, among other things, the AICPA, SEC, PCAOB, and GAO independence rules and qualifies for four hours of CPE credits. See www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Ethics/PRDOVR~PC-739155HS/PC-739155HS.jsp.

.101 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.102 AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $145 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics. Some courses that address ethics and independence issues include the following:

- 2010 Annual A&A Update—Issues for Audits of Public Entities
- 2010 Annual A&A Update—Other Issues Affecting Auditors

- 2010 Public Company Update: SEC Guidance (Part 1 of 2)
- 2010 Public Company Update: SEC Guidance (Part 2 of 2)
- Compilations and Reviews: Independence Considerations
- Comp & Review Engagements: Recent SSARS Developments and Current Practice Issues
- Comp & Review Engagements: Current Practices; Accounting & Reporting Issues; Potential Change
- Current SEC and PCAOB Developments during Q1 2010
- Ethics: AA&C LLP—Accounting Firm Practice Development Committee
- Ethics: BAN&K Advisory Services LLC—You Are the Audit Partner
- Ethics: Department of Enforcement—You Are the Accounting Investigator
- Ethics: Forensic Review Services LLC—You Are the Forensic Auditor
- Ethics: Incisive Lasers Corporation—You Are the Outside Counselor
- Ethics: Megatron Corp.—You Are the Corporate Controller
- Ethics: Military Communications Corp.—You Are the Outside Tax Advisor
- Ethics: Pointer Electronics, Inc.—You Are the Audit Partner
- Ethics: Precious Mining Inc.—You Are the Audit Committee Chair
- Ethics: Radar One, LLP—You Are the Amended Return Preparer
- Ethics: Scrap Metal Aggregators, Inc.—You Are the Tax Return Preparer
- Ethics: Superlative Software, Corp.—You Are the CFO
- In a CPA's Professionalism We Must Trust
- Single Audit & Yellow Book Deficiencies: Independence & Single or Program-Specific Audit
- Small Business Auditing: Independence Considerations
- Yellow Book: Ethical Principles and General Standards

To register or learn more, visit www.cpa2biz.com.

Webcasts

.103 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BiZ_Nav/Top/Browse/Primary/Webcasts.jsp.

Member Service Center

.104 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.105 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. EST

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on weekdays. You can reach the Technical Hotline at (888) 242-7212, by email at aahotline@aicpa.org, or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

.106 The AICPA offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA code. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

AICPA Governmental Audit Quality Center

.107 The Governmental Audit Quality Center (GAQC) is a firm-based, voluntary membership center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC's primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm's governmental audits.

.108 The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits
- Serve as a comprehensive resource provider on governmental audits for member firms
- Create a community of firms that demonstrates a commitment to governmental audit quality
- Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues
- List member firms to enable purchasers of governmental audit services to identify firms that are members
- Provide information about the center's activities to other governmental audit stakeholders

For more information about the GAQC, visit www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx.

The Center for Audit Quality

.109 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.110 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that provides education, communication, representation, and other means to member firms that audit or are interested in auditing public companies. To learn more about the CAQ, visit www.aicpa.org/InterestAreas/CenterForAuditQuality/Pages/CAQHome.aspx.

AICPA Employee Benefit Plan Audit Quality Center

.111 The AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) is a firm-based, voluntary membership organization for firms that perform or are interested in performing ERISA employee benefit plan audits. The EBPAQC was established to promote the quality of employee benefit plan audits.

.112 To achieve this goal, the EBPAQC has created a community of firms that demonstrate a commitment to employee benefit audit quality, and it supports those firms by doing the following:

- Providing members with timely communication of regulatory developments, best practices guidance, and technical updates
- Providing members with an online community forum for sharing best practices, as well as discussions on audit, accounting, and regulatory issues
- Maintaining relationships with, and acting as a liaison to, the DOL on behalf of member firms
- Providing center members with a marketing toolkit to facilitate promotion of their membership in the center
- Providing information about the center's activities to other employee benefit plan stakeholders

.113 The increasing complexity of employee benefit plan auditing and increased scrutiny by the DOL have resulted in a significant number of changes and issues for auditing firms and CPAs in general. Firms and CPAs will benefit from the assistance of the center as a resource for improving employee benefit plan audit quality.

.114 For more information about the EBPAQC, visit www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Pages/EBPAQhomepage.aspx.

Industry Websites

.115 The Internet covers a vast amount of information that may be valuable to auditors, including current industry trends and developments. Some of the more relevant sites for auditors include those shown in the following table:

Website Name	*Content*	*Website*
AICPA	Summaries of recent auditing and other professional standards, as well as other AICPA activities	www.aicpa.org www.cpa2biz.com www.ifrs.com
AICPA Professional Ethics Executive Committee (PEEC)	AICPA Code of Professional Conduct; PEEC standards setting projects and meeting information; information on the ethics enforcement process, including discipline actions; as well as an array of other resources	www.aicpa.org/InterestAreas/ProfessionalEthics/Pages/ProfessionalEthics.aspx
Board of Governors of the Federal Reserve System (FRB)	Advisory dated 2006 regarding the use of limitation of liability provisions in engagement letters with public and nonpublic financial institutions	www.federalreserve.gov/boarddocs/srletters/2006/SR0604a1.pdf
Department of Labor (DOL)	DOL Regulation 2509.75-9, *Interpretive bulletin relating to guidelines on independence of accountant retained by Employee Benefit Plan*, and contact information	www.dol.gov/
Government Accountability Office (GAO)	*Government Auditing Standards* independence standard, frequently asked questions on independence, slide presentation on independence, and contact information	www.gao.gov/govaud/ybk01.htm/

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Federal Deposit Insurance Corporation (FDIC)	FDIC regulations (12 U.S. *Code of Federal Regulations* [CFR] Part 363), *Annual Independent Audits and Reporting Requirements*	www.fdic.gov/regulations/laws/rules/2000-8500.html#2000part363
International Federation of Accountants (IFAC)	Pronouncements, projects, and key contacts of the International Ethics Standards Board for Accountants (IESBA), including the IESBA's *Code of Ethics for Professional Accountants*	www.ifac.org/Ethics/
Public Company Accounting Oversight Board (PCAOB)	Information on accounting and auditing activities of the PCAOB, including those on independence	www.pcaob.org
Securities and Exchange Commission (SEC)	Information from the Office of the Chief Accountant for accountants and auditors, including independence; current SEC rulemaking; final rule releases 33-8183A and 33-8183, *Strengthening the Commission's Requirements Regarding Auditor Independence*; and key contact information	www.sec.gov

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Appendix—Digest of the AICPA Independence Rules

A plain-English description of the AICPA independence rules follows. The purpose of this section is to help you to understand independence requirements under the AICPA Code of Professional Conduct (code) and, if applicable, other rule-making and standard-setting bodies. *Independence* generally implies one's ability to act with integrity and exercise objectivity and professional skepticism. The AICPA and other rule-making bodies have developed rules that establish and interpret independence requirements for the accounting profession. We use the term *rules* broadly to also mean standards, interpretations, rulings, laws, regulations, opinions, policies, or positions. This guide discusses in plain English the independence requirements of the principal rule-making bodies in the United States so you can understand and apply them with greater confidence and ease.

This section of the alert is intentionally concise, so it does not cover all the rules (some of which are complex), nor does it cover every aspect of the rules herein. Nonetheless, this guide should help you identify independence issues that may require further consideration. Therefore, you should always refer directly to the rules, in addition to your firm's policies on independence, for complete information.

Conventions and Key Terms Used

The following are some of the conventions used in this section of the alert:

- The word ***Note*** in boldface italics emphasizes important points, highlights applicable government regulations, or indicates that a rule change may soon occur.
- AICPA interpretations and rulings to the code are linked.
- Web addresses (universal resource locators or URLs) and hyperlinks to other sources of information are provided.
- Information on additional resources appears at the end of this section to help you resolve your independence issues (see the question "Where Can I Find Further Assistance With My Independence Questions?")

> We describe the rules of the Securities and Exchange Commission (SEC) and Public Company Accounting Oversight Board (PCAOB)—that is, those that apply to audits of SEC registrants and issuers—in boxed text (like this one) and provide citations to specific rules. Generally, we provide these descriptions when the SEC and PCAOB either impose additional requirements or their rules otherwise differ from the AICPA rules.

This section uses the following key terms:

Client (or **attest client**)**.** An entity with respect to which independence is required.

Firm. A form of organization permitted by law or regulation (whose characteristics conform to resolutions of the AICPA council) that is engaged in the practice of public accounting.

SEC Registrant. An issuer filing an initial public offering, a registrant filing periodic reports under the securities laws, a sponsor or manager of an investment fund, or a foreign private issuer that is (or is in the process of becoming) an SEC registrant. In this appendix, *SEC audit client* means an SEC registrant and its affiliates, as defined in the SEC rules.

Issuer. An entity whose securities are registered under the securities laws or that is required to file reports under Section 10(A) of the Securities Exchange Act of 1934 or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933.

Note: Certain SEC registrants (for example, broker-dealers and hedge funds) are not issuers (that is, they are nonissuers). These entities' auditors will not be subject to the PCAOB independence rules and will be exempt from certain SEC independence rules.

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What Is Independence?

Independence is defined in ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*, vol. 2), and is referred to herein as *the conceptual framework*, as follows:

Independence of mind. The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

Independence in appearance. The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

These definitions reflect the long-standing professional requirement that members who provide services to entities for which independence is required be independent both "in fact" (that is, "of mind") and in appearance.

What Should I Do if No Specific Guidance Exists on My Particular Independence Issue?

The "Other Considerations" section of Interpretation No. 101-1, "Interpretation of Rule 101," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .02), recognizes that it is impossible for the code to identify all circumstances in which the appearance of independence might be questioned.

Specifically, Interpretation No. 101-1 requires that members use the risk-based approach described in the conceptual framework when making independence decisions involving matters that are not specifically addressed in the independence interpretations and rulings in the code. When threats to independence are not at an acceptable level, safeguards must be applied to eliminate the threats or reduce them to an acceptable level. In cases when threats to independence are not at an acceptable level, and thereby require the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level must be documented.

The conceptual framework provides a valuable tool to help you comply with the requirement in the "Other Considerations" section to evaluate whether a specific circumstance that is not addressed in the code would pose an unacceptable threat to your independence.

When Is Independence Required, and Who Sets the Rules?

AICPA professional standards require your firm, including the firm's partners and professional employees, to be independent in accordance with Ethics Rule 101 of the code whenever your firm performs an attest service for a client. Attest services include the following:

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

Performing a compilation of a client's financial statements does not require independence. However, if a nonindependent firm issues such a compilation report, the report must state, "I am (we are) not independent with respect to XYZ Company."[1]

You and your firm are not required to be independent to perform services that are not attest services (for example, tax preparation or advice or consulting services, such as personal financial planning), if they are the only services your firm provides to a particular client.

Note: You should familiarize yourself with your firm's independence policies, quality control systems, and list or database of attest clients.

[1] See paragraph .19 of AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*, vol. 2).

In Addition to the AICPA, Who Else Sets Independence Rules?

Many clients are subject to oversight and regulation by governmental agencies. For example, the Government Accountability Office (GAO) sets independence rules that apply to entities audited under *Government Auditing Standards* (also referred to as the Yellow Book). For these clients (and others, such as those subject to regulation by the SEC or Department of Labor [DOL]), you and your firm also must comply with the independence rules established by those agencies.

The SEC regulates SEC registrants and issuers and establishes the qualifications of independent auditors. This section refers to these independence rules as *SEC rules*.

The PCAOB, a private standards-setting body whose activities are overseen by the SEC, is authorized to set, among other things, auditing, attestation, quality control, ethics, and independence standards for accounting firms that audit issuers. The PCAOB adopted interim ethics standards based on the following provisions of the code: Ethics Rule 102, *Integrity and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 102); Ethics Rule 101; and interpretations and rulings under those rules as of April 16, 2003. It also adopted Independence Standards Board (ISB) standards. To the extent that the SEC's rules are more or less restrictive than the PCAOB's interim independence standards, registered public accounting firms must comply with the more restrictive requirements.

In addition to its detailed rules, the SEC looks to its general standard of independence and four basic principles to determine whether independence is impaired. The general standard is an appearance standard that considers whether a reasonable investor with knowledge of all relevant facts and circumstances would conclude that an accountant is independent.

Under the four basic principles, an auditor cannot (*a*) function in the role of management, (*b*) audit his or her own work, (*c*) serve in an advocacy role for the client, or (*d*) have a mutual or conflicting role with the client.

Other organizations that establish independence requirements that may be applicable to you and your firm include the following. You should contact these organizations directly for further information:

- State boards of accountancy
- State CPA societies
- Federal and state agencies

Note: Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule.

Once you determine that your firm provides attest services to a client and which rules apply, the next step is to determine how the rules apply to you.

Applying the Rules—Covered Members and Other Firm Professionals

How Do the Independence Rules Apply to Me?

Whenever you are a covered member, you become subject to the full range of independence rules with regard to a specific client. You are a covered member if you are any of the following:

a. An individual on the client's attest engagement team

b. An individual in a position to influence the client's attest engagement

c. A partner or manager who provides more than 10 hours of nonattest services to the attest client

d. A partner in the office in which the lead attest engagement partner primarily practices in connection with the client's attest engagement

e. The firm, including the firm's employee benefit plans

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f. An entity whose operating, financial, or accounting policies can be controlled[2] by any of the individuals or entities described in items (*a*)–(*e*) or by two or more such individuals or entities if they act together

The SEC uses the term *covered person*[3] to describe the individuals in a firm who are subject to SEC independence rules. This term is largely consistent with the AICPA's term *covered member*. The only difference between the two definitions is that of classification. The AICPA considers consultants to be in a position to influence the engagement (the SEC uses the term *chain of command*), whereas the SEC considers these persons to be on the attest engagement team. Overall, the definitions are the same.

Note: This alert uses the term *covered member* (and *covered person* with respect to SEC rules) extensively in explaining the "personal" independence rules (for example, rules that apply to you and your family's loans, investments, and employment). Therefore, it is important that you understand these terms before proceeding. Also, remember to check your firm's policies to determine whether they are more restrictive than the AICPA or SEC rules.

Do Any of the Rules Apply to Me if I Am Not a Covered Member?

Yes, these rules apply in certain circumstances, even if you are not a covered member. Due to their magnitude, two categories of relationships impair independence even if you are not a covered member. These relationships are defined as follows:

- Director, officer, or employee (or in any capacity equivalent to a member of management) of the client, promoter, underwriter, voting trustee, or trustee of any of the client's employee benefit plans
- Owner of more than 5 percent of an attest client's outstanding equity securities (or other ownership interests)

The independence rules prohibit these relationships if you are a partner or professional employee in a public accounting firm.

What if I Was Formerly Employed by a Client, or I Was a Member of the Client's Board of Directors?

You must be aware of a number of things, including the following:

- You may not participate in the client's attest engagement, or be in a position to influence the engagement, for any periods covering the time that you were associated with the client. So, for example, if you worked for the client in 2009, you would be prohibited from serving on the client's audit engagement for the fiscal year 2009 financial statements. You also could not serve in a position that would allow you to influence the fiscal 2009 engagement (for example, you could not directly or indirectly supervise the audit engagement partner).
- Before becoming a covered member, you must do the following:
    - — Dispose of any direct or material indirect financial interests in the client[4]
    - — Collect and repay all loans to or from the client (except those specifically permitted or grandfathered).[5]
    - — Cease active participation in the client's employee health and welfare plans (except for benefits under the Consolidated Omnibus Budget Reconciliation Act of 1985).
    - — Cease to participate in all other employee benefit plans by liquidating or transferring all vested benefits in the client's defined benefit plans, defined contribution plans, share-based

[2] As defined by generally accepted accounting principles for consolidation purposes.

[3] See Rule 2-01(f)(11). Also, see "Covered Persons in the Firm," in the Security and Exchange Commission' s (SEC's) Final Rule Release [Section IV (H)(9)].

[4] See the section, "When Do My (or My Family's) Financial Interests Impair Independence?" in this appendix.

[5] Also see Interpretation No. 101-5, "Loans From Financial Institution Clients and Related Terminology," under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .07).

compensation arrangements, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. When the covered member does not participate on the attest engagement team or is not in a position to influence the attest engagement, he or she is not required to liquidate or transfer any vested benefits if such an action is not permitted under the terms of the plan or if a penalty[6] significant to the benefits is imposed upon such liquidation or transfer.

— Assess if you have any other relationships with the client to determine if such relationships create threats to independence that would require the application of safeguards to reduce the threats to an acceptable level.[7]

What Rules Apply if I Am Considering Employment With an Attest Client?

If an attest client offers you employment or you seek employment with an attest client, you may need to take certain actions. If you are on that client's attest engagement team or can otherwise influence the engagement, you must promptly report any employment negotiations with the client to the appropriate person in your firm. You cannot participate in the engagement until your negotiations with the client end.

What if I Accept Employment or a Board Position With an Attest Client?

Being employed by a client or a member of the client's board of directors impairs independence. However, even if you leave your firm to take a position with a client, independence still may be affected. This would be the case if you accept a key position with the client, which means that you prepare financial statements or accounting records or are otherwise able to influence the client's statements or records. A few examples of key positions are controller, CFO, or treasurer. Remember that the substance, and not only the position title, determines whether a position is considered "key."

If you meet the following conditions, having a key position with a client will not impair your firm's independence:

- The amounts that the firm owes you (capital balance or retirement benefits) are based on a fixed formula and are not material to the firm.
- You cannot influence the firm's operations or financial policies.
- You do not participate or appear to participate in the firm's business or professional activities.

Your firm must consider whether it should apply additional procedures to ensure that your transition to the client has not compromised the firm's independence and that independence will be maintained going forward. Some things the firm should consider are the following:

- Whether you served on the engagement team and for how long
- Positions you held with the firm and your status
- Your position and status with the client
- The amount of time that has passed since you left the firm

Based on these factors, the firm may decide to do the following:

- Adjust the audit plan to reduce the risk that your knowledge of the plan could lessen the audit's effectiveness
- Reconsider the successor engagement team to ensure it has sufficient stature and experience to deal effectively with you in your new position

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[6] A penalty includes an early withdrawal penalty levied under the tax law but excludes other income taxes that would be owed, or market losses that may be incurred, as a result of the liquidation or transfer.

[7] See the section, "What Should I Do if No Specific Guidance Exists on My Particular Independence Issue?" in this appendix.

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- Perform an internal technical review of the next attest engagement to determine whether engagement personnel exercised the appropriate level of professional skepticism in evaluating your work and representations[8]

Under SEC rules, if a former partner will be in an accounting role or financial reporting oversight role with an SEC audit client, he or she may not have the following:

- A capital balance with the firm
- A financial arrangement with the firm (for example, retirement benefits) that is not fully funded by the firm
- Influence over the firm's operations or financial policies

The SEC uses the terms *accounting role* and *financial reporting oversight role*[9] in its rules; taken together, these terms are consistent with the AICPA term *key position*. The SEC also requires a one year cooling-off period for members of the audit engagement team of an issuer who assume a financial reporting oversight role with the client. In other words, if an engagement team member who participated on the audit of the current (or immediately preceding) fiscal year goes to work for a client, the firm's independence would be impaired.

Only members who provided fewer than 10 hours of audit, review, or other attest services to the client (and did not serve as either the lead or concurring partner for the client) would be excluded from the audit engagement team for purposes of this rule.

This rule applies to an issuer and its consolidated entities.

Applying the Rules—Network Firms

What is a Network Firm?

CPA firms frequently form associations with other firms and entities and cooperate with them to enhance their capabilities to provide professional services. On occasion, such cooperation creates the appearance that firms are closely aligned or connected. Such appearance exists when one or more of the following characteristics are present:

- The use of a common brand name (including common initials) as part of the firm name
- Common control (as defined by generally accepted accounting principles in the United States of America) among the firms through ownership, management, or other means
- Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm
- Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association's strategy and are held accountable for performance pursuant to that strategy
- Significant part of professional resources
- Common quality control policies and procedures that firms are required to implement and that are monitored by the association

When a firm participates in such an association and one or more of the preceding characteristics are present, the firm is considered a network firm. Any entity that the firm controls by itself or through one or more of its owners is also considered a network firm. In addition, any entity that can control the firm or that the firm is under common control by would also be considered a network firm.

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[8] An objective professional with the appropriate stature and expertise should perform this review, and the firm should take any recommendation(s) that result from the review.

[9] *Accounting role* or *financial reporting role* means a role in which a person is in a position to or does (*a*) exercise more than minimal influence over the contents of the accounting records or anyone who prepares them, or (*b*) exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of a board of directors or similar management or governing body, CEO, president, CFO, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.

It is possible that not all firms in the association will meet one of the preceding characteristics. In such situations, only the subset of firms that meet one or more of the characteristics would be considered network firms.

How Do I Apply the Network Firm Rules?

Interpretation No. 101-17, "Networks and Network Firms," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .19), explains that when your firm is considered a network firm, your firm is required to remain independent of other network firm's audit and review clients and vice versa. Thus, a network firm may provide audit or review services for a client only insofar as other network firms are independent of the client. For example, other network firms could not provide prohibited nonattest services (that is, services that would impair independence under Interpretation No. 101-3, "Performance of Nonattest Services," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05) for that client or have any prohibited relationships such as investments by the firm in the client, or loans to or from that client. For all other attest clients, network firms should consider any threats the firm knows or has reason to believe may be created by network firm interests and relationships. If those threats are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level.

When determining if a network exists, the SEC would look at all the facts and circumstances, especially how the firms treat one another when referring audit work (that is, do they place reliance on the work received by another firm or do they treat the work the same as if an unaffiliated firm performed the work). At the SEC/PCAOB conference on December 10, 2007, it was noted that the SEC staff continue to follow the guidance issued in its January 2001 independence rule-making regarding its definitions of *firm* and *affiliate*—that is, staff will consider specific facts and circumstances, including the following:

- Does the primary auditor refer to another network firm in their audit opinion?
- Do the firms have common ownership, profit sharing, or cost sharing agreements?
- Do the firms share management, have a common brand name, or use shared professional resources?
- Do the firms have common quality control policies and procedures?

When Are the Rules Effective?

This guidance is effective for engagements covering periods beginning on or after July 1, 2011.

Applying the Rules—Family Members

When Is My Family Subject to the Rules?[10]

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

This general rule has the following exceptions:

a. Your immediate family member's employment with a client would not impair your firm's independence, provided he or she is not in a key position.

b. Immediate family members in permitted employment positions may participate in certain employee benefit plans that are attest clients or are sponsored by an attest client provided the plan is offered to all employees in comparable positions, and the immediate family member does not serve in a position of governance for the plan or have the ability to supervise or participate in the plan's investment decisions or selection of investment options.

[10] This guidance was updated by the Professional Ethics Executive Committee and is effective on June 1, 2011. Early application is permitted.

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c. Immediate family members of certain covered members may invest in a client through an employee benefit plan (for example, retirement or savings account), provided the immediate family member has no other investment options available for selection and when such option becomes available, the immediate family member selects the option and disposes of any direct or material indirect financial interest in the attest client.

d. Immediate family members in permitted employment positions of certain covered members may participate in share-based compensation arrangements and nonqualified deferred compensation plans provided certain safeguards are implemented.

e. The covered members whose families may invest or participate in the plans described in items (*c*) and (*d*) are as follows:

i. Partners and managers who provide only nonattest services to the client

ii. Partners who are covered members only because they practice in the same office where the client's lead attest partner practices in connection with the engagement

At no time may any direct or material indirect financial interests in an attest client permitted by the preceding exceptions exceed 5 percent of the attest client's outstanding equity securities or other ownership interests.

The SEC rules concerning holding unexercised stock options require the immediate family member to exercise or forfeit vested stock options as soon as the closing market price of the underlying stock equals or exceeds the exercise price. The AICPA rule recognizes that a privately held entity may not have a ready market for its shares, or that thinly traded securities may have volatile markets. Therefore, the triggering event requiring an immediate family member to exercise his or her vested stock options occurs when the market price of the underlying stock equals or exceeds the exercise price for 10 consecutive days.

Alternatively, the SEC's rules concerning employee stock ownership plans (ESOPs) are more restrictive than the AICPA rules in that the immediate family member must dispose of the publicly traded shares received as soon as possible. Because the AICPA rules deal exclusively with private sector securities, it is possible that when the immediate family member receives shares from an ESOP, he or she may not be able to dispose of the shares because there is not a ready market for the shares. Accordingly, the AICPA rules allow the immediate family member to require the employee to exercise his or her put option for the employer to repurchase the shares as soon as permitted by the ESOP terms. If the employer does not pay for the repurchase shares within 30 days, the repurchase obligation must be immaterial to the covered member during the payout period.

What About My Other Close Relatives?

The close relatives (siblings, parents, and nondependent children) of most covered members are subject to some employment and financial restrictions. Your close relative's employment by a client in a key position impairs independence, except for covered members who provide only nonattest services to a client.

Rules pertaining to your close relatives' financial interests differ depending on why you are considered a covered member:

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

— enables the relative to exercise significant influence over the client.

Under SEC rules, your close family members include your spouse (or equivalent) and dependents, your parents, nondependent children, and siblings. If you are a covered person, your independence is affected if your close family member

- has an accounting role or financial reporting oversight role with the SEC audit client (for example, the family member is a treasurer, CFO, accounting supervisor, or controller) or
- owns more than 5 percent of a client's equity securities or controls the client.

In addition, independence is considered to be impaired if any partner's close family member controls an SEC audit client.

Financial Relationships

When Do My (or My Family's) Financial Interests Impair Independence?

This section discusses various types of financial relationships and how they affect independence. Although this section focuses on how these rules apply to you and your family, keep in mind that your firm also is subject to the financial relationship rules (because firms are included in the AICPA definition of *covered member*).

As a covered member, you (and your spouse or equivalent and dependents) are not permitted to have the following:

- A direct financial interest in that client, regardless of how immaterial it would be to your net worth
- A material indirect financial interest in that client

Note: The code does not define, or otherwise provide, guidance on determining materiality. In determining materiality, you should apply professional judgment to all relevant facts and circumstances and refer to applicable guidance in the professional literature. Both qualitative and quantitative factors should be considered.

In addition, if you commit to acquire a direct or material indirect financial interest in a client, your independence would be impaired. For example, if you sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

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

The following types of financial interests are *direct financial interests*:

- Owned by you directly
- Under your control
- Beneficially owned[11] by you through an investment vehicle, estate, trust, or other intermediary if you can either
  - — control the intermediary or
  - — have the authority to supervise or participate in the intermediary's investment decisions.

For example, if you invest in a participant-directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

[11] A financial interest is beneficially owned if an individual or entity is not the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or the disposition of the interest or to receive the economic benefits of the ownership of the interest.

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You also have a direct financial interest in a client if you have a financial interest in a client through one of the following:

- A partnership, if you are a general partner
- A Section 529 savings plan, if you are the account owner
- An estate, if you serve as an executor and meet certain other criteria
- A trust, if you serve as the trustee and meet certain other criteria

For example, suppose you are a covered member with respect to ABC Co., and you are also a general partner of XYZ Partnership. XYZ Partnership owns shares in ABC Co. Under the independence rules, you would be deemed to have a direct financial interest in ABC Co., which would impair your independence, regardless of materiality.

An indirect financial interest arises if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary's investment decisions.

For example, if you invest in a defined contribution plan that is not participant directed and you have no authority to supervise or participate in the plan's investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments, in addition to a direct financial interest in the plan.

Note: Interpretation No. 101-15, "Financial Relationships," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .17), provides extensive examples of various types of financial interests and whether they should be considered to be direct or indirect financial interests, including investments in mutual funds, retirement and savings plans, Section 529 plans, trusts, partnerships, and insurance products.

The SEC classifies your investment in an SEC audit client held through another entity (the intermediary) as direct if either of the following is true:

- You participate in the intermediary's investment decisions or have control over them.
- The investment in the client by the intermediary (that is not a diversified mutual fund) represents 20 percent or more of the value of its total investments.

If neither of the preceding applies, your investment in an SEC audit client through another entity would normally be considered to be an indirect financial interest in that client.

What if My Immediate Family or I Receive a Financial Interest as a Result of an Inheritance or a Gift?

If, due to an unexpected event, you or members of your immediate family receive a financial interest in an attest client that would impair your independence, you may qualify under an exemption in the rules if you meet the following criteria:

- The financial interest was unsolicited.
- You dispose of the interest as soon as practicable, but no later than 30 days after you become aware of it and have the right to dispose.
- If you do not have the right to dispose of the interest (for example, as in the case of stock options or restricted stock), you do not participate in the attest engagement for the client.

What Are the Rules That Apply to My Mutual Fund Investments (and Those of My Family) if My Firm Audits Those Mutual Funds?

If you are a covered member with respect to a mutual fund attest client of your firm and you or your immediate family own shares in the fund, you have a direct financial interest in the fund client.

The SEC rules also prohibit the firm and covered persons and their immediate family members from having any financial interest in an entity (even one that is not a client) that is part of an investment company complex that includes an SEC audit client.

Which Rules Pertain to My Mutual Fund Investments (and Those of My Family) if My Firm Audits Companies Held in Those Mutual Funds?

Financial interests that you and your immediate family have in clients through a mutual fund are considered to be indirect financial interests in those clients unless the fund is a diversified mutual fund.

If a mutual fund is diversified and you or your immediate family, or both, own 5 percent or less of its outstanding shares, the fund's holdings in clients for which you are a covered person will *not* be considered material indirect financial interests in those clients. Thus, you would be relieved of the burden of having to monitor whether, and to what degree, the fund invests in audit clients for which you are a covered person.

If the fund is not diversified or you or your family, or both, own more than 5 percent of the fund's equity, you should treat the fund's holdings as indirect financial interests.

For example, suppose ABC Mutual Fund, a diversified mutual fund, owns shares in a client, XYZ, and

- ABC Mutual Fund's net assets are $10,000,000;
- your shares in ABC Mutual Fund are worth $50,000;
- ABC Mutual Fund has 10 percent of its assets invested in XYZ; and
- your indirect financial interest in XYZ is $5,000 ($50,000 x .10).

If $5,000 is material to your net worth, independence would be considered to be impaired.

May I Have a Joint Closely Held Investment With a Client?

As a covered member, if you or the client individually or collectively controls an investment, that investment is considered to be a joint closely held investment. If this joint closely held investment is material to your net worth, independence would be considered to be impaired. In this rule, the term *client* includes certain persons associated with the client, such as officers, directors, or owners who are able to exercise significant influence over the client.

The SEC rules prohibit you and your immediate family from having a joint business venture with an SEC audit client or persons associated with the client in a decision-making capacity (meaning officers, directors, or substantial shareholders), regardless of whether the venture is material to your net worth. The SEC believes that these joint ventures, whether material or not, cause the client and the audit firm to have mutuality of interests, which impairs independence.

May My Family or I Borrow Money From or Lend Money to a Client?

If you are a covered member with respect to an attest client, you and your immediate family may not have a loan to or from the following:

- The client
- An officer or director of the client
- An individual holding 10 percent or more of the client's outstanding equity securities (or other ownership interests)

Certain exceptions affect this rule. First, specific loans exist that covered members are permitted to have from financial institution attest clients. They are the following:

- Car loans and leases collateralized by the vehicle

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- Credit card and overdraft reserve account balances that are kept current and do not exceed $10,000 (by payment due date, including any grace period)
- Passbook loans fully collateralized by cash deposits at the same financial institution
- Loans fully collateralized by an insurance policy

In addition, if you have a loan from a client financial institution (a bank, for example) that meets certain criteria, your loan may be grandfathered (that is, you may be allowed to keep it). For your loan to be grandfathered, you must have obtained it under normal lending procedures, terms, and requirements. The following loans may be grandfathered:

- Home mortgages
- Other secured loans
- Unsecured loans that are immaterial to your net worth

Generally speaking, a loan may be grandfathered if you obtained it before any of the following:

- You became a covered member with respect to the client.
- The financial institution became a client.
- The client acquired the loan.

To maintain your loan's grandfathered status, you must keep the loan current (that is, make timely payments according to the loan agreement). Also, you cannot renew or renegotiate the terms of the loan (for example, the interest rate or formula) unless the change was part of the original agreement (for example, an adjustable rate mortgage).

> The SEC rules differ from the AICPA rules in that secured loans (other than a mortgage on your primary residence) and immaterial unsecured loans may not be grandfathered.

May I Have a Brokerage Account With a Client?

The AICPA rules indicate that for independence to be maintained, a covered member whose assets are held by a broker-dealer client must not receive any preferential treatment or terms, and any assets that are subject to risk of loss must be immaterial to the covered member's net worth. In addition, margin accounts may be subject to the preceding loan rules.[12]

> Under the SEC rules, you may have a brokerage account with an SEC audit client if your account (*a*) only holds cash or securities and (*b*) is fully insured by the Securities Investor Protection Corporation.

May I Have a Bank Account With a Client?

As a covered member, you may have a bank account with a client financial institution (for example, checking, savings, money market accounts, and certificates of deposit) if your deposits are fully insured by state or federal deposit insurance agencies or if uninsured amounts are not material to your net worth.[13]

> The SEC prohibits covered persons and their immediate families from having bank account balances with an SEC audit client in excess of Federal Deposit Insurance Corporation (FDIC) insurance limits. That is, deposits in excess of FDIC limits are considered to impair independence even if the amounts are immaterial to you and your family.[14]

[12] See the preceding question, "May My Family or I Borrow Money From or Lend Money to a Client?" in the "Financial Relationships" section in this appendix.

[13] Both AICPA and SEC rules permit a practical exception for firms that maintain deposits exceeding insured limits when the likelihood of the financial institution experiencing financial difficulties is considered remote.

[14] The SEC treats money market funds (as opposed to money market accounts) as mutual funds for the purposes of their rules. Also see Rule 2-01(c)(1)(B).

May I Have an Insurance Policy With a Client?

The AICPA rules[15] indicate that, to maintain independence, a covered member must not receive any preferential treatment or terms when purchasing an insurance policy from a client. If the policy has an investment option, the financial interest rules must be applied.

The SEC prohibits covered persons and their immediate family members from owning an individual insurance policy issued by an SEC audit client unless both of the following criteria are met:

- He or she obtained the policy before the professional became a covered person.
- The likelihood of the insurer becoming insolvent is remote.

May I Give Gifts or Entertainment to or Accept Gifts or Entertainment From a Client?

An ethics ruling[16] addresses the exchange of gifts and entertainment among covered members, the attest client, and certain persons associated with the client (for example, persons in key positions and persons owning 10 percent or more of the client's outstanding equity securities or other ownership interests).

Independence is impaired if the firm, a member of the attest engagement team, or a person able to influence the engagement accepts a gift that is not clearly insignificant.

A covered member may give a gift to persons associated with the client and not impair independence if the gift is reasonable in the circumstances. In addition, covered members may give or receive entertainment, provided it was reasonable in the circumstances.

Another ethics ruling[17] addresses the broader issue of integrity and objectivity when partners, professionals, or their firms exchange gifts or entertainment with clients or persons associated with clients. Generally, gifts are differentiated from entertainment by whether the client participates in the activity with the firm member (for example, giving tickets to a sporting event for the client to use would be considered a gift versus attending the event with the client, which would be considered entertainment).[18]

Relevant factors in determining *reasonableness* include the event or occasion (if any) giving rise to the gift or entertainment, cost or value, frequency, whether business was conducted, and who participated.

Business Relationships

Which Business Relationships With a Client Impair Independence?

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

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

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

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[15] The guidance is found in the "Insurance Products" portion of Interpretation No. 101-15, "Financial Relationships," under Rule 101 (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .17).

[16] See Ethics Ruling No. 114, "Acceptance or Offering of Gifts and Entertainment to or From an Attest Client," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .228–.229).

[17] See Ethics Ruling No. 113, "Acceptance or Offering of Gifts or Entertainment," of ET section 191 (AICPA, *Professional Standards*, vol. 2, ET sec. 191 par. .226–.227).

[18] See www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/Gifts_Basis_Document.pdf.

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

Two possible exceptions apply to this rule:

- If you are an honorary director or trustee for a client that is a nonprofit charitable, civic, or religious organization, you may hold such position with a client if
  - your position is purely honorary,
  - you do not vote or participate in managing the organization, or
  - your position is clearly identified as honorary in any internal or external correspondence.
- In addition, you may serve on a client's advisory board if all of the following criteria are met:
  - The board's function is purely advisory.[19]
  - The board does not appear to make decisions for the client.
  - The advisory board and any decision making boards are separate and distinct bodies.
  - Common membership between the advisory board and any decision making groups is minimal.

The SEC prohibits direct or material indirect business relationships with an SEC audit client (or persons associated with a client), except when the firm is acting as a consumer in the ordinary course of business (for example, purchasing goods or services from a client at normal commercial terms, and these goods or services will be consumed by the firm). Examples of prohibited business relationships include joint business ventures, limited partnership agreements, and certain leasing interests.

Nonattest Services

Which Rules Describe the Nonattest Services That My Firm and I May or May Not Provide to Attest Clients?

The term *nonattest services* include accounting, tax, and consulting services that are not part of an attest engagement.[20] Nonattest services specifically addressed in the rules are the following:

- Bookkeeping services
- Nontax disbursement services
- Internal audit assistance
- Benefit plan administration
- Investment advisory or management services
- Tax compliance services
- Corporate finance consulting or advisory services
- Appraisal, valuation, or actuarial services
- Executive or employee search services
- Business risk consulting
- Information systems design, installation, or integration

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[19] When evaluating your independence under this rule, you should examine the applicable board or committee charter to determine whether it is consistent with this ethics ruling.

[20] Defined in the AICPA Code of Professional Conduct, an *attest engagement* is one that requires independence under AICPA professional standards; for example, audits and reviews of financial statements or agreed-upon procedures performed under the attestation standards are considered attest engagements.

- Forensic accounting services

In addition to considering the general standard and four guiding principles, the SEC rules generally prohibit a CPA from providing the following services to an SEC audit client during the audit and professional engagement period:

- Bookkeeping and other services related to the client's accounting records or financial statements
- Financial information systems design and implementation
- Appraisal or valuation services
- Actuarial services
- Internal audit outsourcing
- Management functions
- Human resources
- Broker-dealer, investment adviser, or investment banking
- Legal services
- Expert services unrelated to the audit

Under PCAOB rules, the following types of services also are subject to significant restrictions if the auditor provides them to an issuer during the audit and professional engagement period:

- Aggressive or confidential tax transactions
- Personal tax services provided to persons in financial reporting oversight roles

If your firm performs nonattest services for an attest client, the independence rules impose limits on the nature and scope of the services that your firm may provide. In other words, the extent to which your firm may perform certain tasks will be limited by the rules. Further, certain services will be prohibited in total (for example, serving as a client's general counsel). These rules apply during the period of the professional engagement and the period covered by the financial statements (to which the attest services relate). In addition, the AICPA staff issued a frequently asked question (FAQ), "Period of the Professional Engagement," which clarifies how the rules apply to nonattest services provided to a new attest client prior to the time of engagement.

In August 2007, the SEC staff updated its FAQ document titled *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions*. FAQ No. 7 under "Prohibited and Non-audit Services" addresses the question of whether a successor auditor who performed one of the preceding services during the audit period (period covered by the financial statements) would be independent of an SEC audit client. The FAQ states that if the services (*a*) relate solely to the prior period audited by the predecessor auditor and (*b*) were performed before the successor auditor was engaged to audit the current audit period, independence would not be impaired.

This section does not discuss each of these services, but rather focuses on a few for purposes of illustration. To see the full context of the rules, see Interpretation No. 101-3 and SEC Rule 2-01(c)(4), "Non-audit services." You also are encouraged to review the Nonattest Services FAQs developed by the Professional Ethics Division and the Prohibited and Non-audit Services FAQs developed by the SEC's Office of the Chief Accountant.

The AICPA rules require a member to comply with more restrictive independence provisions, if applicable, of certain regulators, such as state boards of accountancy and the SEC, GAO, and DOL.

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SEC and PCAOB rules require independence of an issuer that is an audit client and various affiliated entities of the client.[21]

Note: SEC rules also require a client's audit committee (or equivalent) to preapprove all audit and nonaudit services provided by the firm to an issuer and the issuer's consolidated entities. Proposals to provide tax or internal control-related services are subject to more extensive audit committee preapproval requirements under PCAOB Rule 3524, *Audit Committee Pre-approval of Certain Tax Services*, and Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board).

PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), superseded the PCAOB's interim standard, ISB Standard No. 1, *Independence Discussions with Audit Committees*, and its interpretations. Before accepting a new audit engagement and annually thereafter, the auditor must describe in writing to the issuer's audit committee all relationships between the auditor and the client (including affiliates of both) that could reasonably be thought to bear on independence, discuss these matters with the audit committee, and document the substance of that discussion (effective September 30, 2008).

AICPA General Requirements

General Requirement 1

One of the key principles underlying the AICPA rules on nonattest services is that you may not serve—or even appear to serve—as a member of a client's management. For example, you may not do any of the following:

- Make operational or financial decisions for the client
- Perform management functions for the client
- Report to the board of directors on behalf of management

In addition, the following are examples of the types of activities that impair independence:

- Authorizing or executing a transaction on behalf of a client
- Preparing the client's source documents (for example, purchase orders)
- Having custody of a client's assets
- Establishing or maintaining internal controls, including monitoring ongoing activities

General Requirement 2

To help ensure compliance with the first general requirement, the second requirement states that the client must agree to assume certain responsibilities related to the nonattest services engagement. So prior to agreeing to perform any nonattest services for the client, the firm must obtain the client's agreement to

a. make all management decisions and perform all management functions;

b. designate an individual who possesses suitable skill, knowledge, and experience, preferably within senior management, to oversee the services;

c. evaluate the adequacy and results of the services performed; and

d. accept responsibility for the results of the services.

With regard to item (*b*) in the preceding list, the firm should be satisfied that the client's designee sufficiently understands the services to be performed to oversee them. This does not mean that the individual must be able to perform or reperform the services. It means that he or she should be able to understand and agree to the nature, objectives, and scope of the services; make all significant judgments; evaluate the adequacy and results of the service; accept responsibility for the service results; and ensure that the resulting work product

[21] See Rule 2-01(f)(4) and (6).

meets the agreed-upon specifications. The client also must be willing to commit the time and resources needed for the designee to fulfill these duties.

General Requirement 3

Before performing nonattest services, the firm should establish and document its understanding with the client regarding the following:

- Objectives of the engagement
- Services to be performed
- Client's acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

The firm should document the understanding in the engagement letter, audit planning memo, or other internal firm file.

Note: Routine activities (for example, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements) that are part of the normal member-client relationship are exempt from the second and third general requirements.

What Are the Rules Concerning Performing Bookkeeping Services for a Client?

The AICPA independence rules prohibit members from acting as client management in all circumstances. Accordingly, a member may provide bookkeeping services if the client oversees the services and, among other things, performs all management functions and makes all management decisions in connection with the services. For example, if a member is engaged to provide bookkeeping services that will result in a set of financial statements, the client must do the following:

- Approve all account classifications
- Provide source documents to the member so that the member can prepare journal entries
- Take responsibility for the results of the member's services (for example, financial statements)

Note: Proposing adjusting entries to a client's financial statements as a part of the member's audit, review, or compilation services is considered a normal part of those engagements and would not be considered the performance of a nonattest service subject to the general provisions of Interpretation No. 101-3, provided the client reviews these entries, understands the impact on its financial statements, and records any adjustments identified by the member.

Because of self-audit concerns, performing any type of bookkeeping service for an SEC audit client is considered to impair independence under SEC rules unless it is reasonable to expect that the results of the auditor's services will not be subject to the firm's audit procedures. The SEC considers there to be a rebuttable presumption that the results of these services would be subject to audit procedures and, therefore, the firm must overcome the presumption to perform the service.

This presumption of self audit also applies to (*a*) financial information design and implementation; (*b*) appraisals, valuations, fairness opinions, or contribution-in-kind reports; (*c*) actuarial-related advisory services; and (*d*) internal audit outsourcing.

May My Firm Provide Internal Audit Assistance to a Client?

To perform internal audit assistance for a client and maintain independence, your firm may not act—or appear to act—as a member of the client's management. For example, you and your firm may not do the following:

- Make decisions on the client's behalf
- Report to the client's governing body

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To maintain independence, the client must do the following:

- Designate an individual or individuals who possess suitable skill, knowledge, and experience to oversee the internal audit function
- Determine the scope, risk, and frequency of internal audit activities
- Evaluate the findings and results of internal audit activities
- Evaluate the adequacy of the audit procedures performed and related findings

Internal audit services provided to an SEC audit client impair independence unless it is reasonable to expect that the results of the auditor's services would not be subject to the firm's audit procedures.

Note: For entities regulated by the FDIC or other banking agencies, see www.fdic.gov/news/news/financial/2009/fil09033.html.

May My Firm Manage a Project For a Client?

In February 2010, the staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of two FAQs) on the question of whether a member's independence would be impaired if he or she either managed a project for a client or assisted management in determining whether to proceed with a project. If the member makes the decision regarding whether to proceed with the project or takes responsibility for the management of the project, then the member's independence would be impaired even if the project did not affect the client's financial statements.

However, if the member's services were limited to providing assistance, advice, suggestions, or recommendations regarding matters that are within his or her areas of knowledge or experience, independence would not be impaired.

May My Firm Provide Valuation, Appraisal, or Actuarial Services to a Client?

Your firm may not provide valuation, appraisal, or actuarial services to a client if

- the results of the service would be material to the client's financial statements, and
- the service involves a significant amount of subjectivity.

For instance, your firm may not perform a valuation in connection with a business combination that would have a material effect on a client's financial statements because that service involves significant subjectivity (for example, setting the assumptions and selecting and applying the valuation methodology).

Two limited exceptions to this rule apply. First, valuation, appraisal, or actuarial services performed for nonfinancial statement purposes may be provided if they otherwise meet the rule's general requirements (for example, the client assigns an individual who is in a position to make an informed judgment on and accept responsibility for the results of the service to oversee the service). Also, your firm may provide an actuarial valuation of a client's pension or postretirement liabilities because the results of the valuation would be reasonably consistent, regardless of who performs the valuation.

The SEC prohibits your firm from providing valuation, appraisal, or any service involving a fairness opinion or contribution-in-kind report[22] to an SEC audit client unless it is reasonable to expect that your firm would not audit the results of those services.

In August 2008, the staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of an FAQ) on the question of whether, under Interpretation No. 101-3, members could assist an attest client in applying Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 805, *Business Combinations*, or FASB ASC 350, *Intangibles—Goodwill and Other*, while maintaining independence. Specifically, the FAQ addresses whether the following services would be considered to impair independence:

[22] Per the SEC, *fairness opinions* and *contribution-in-kind* reports are opinions and reports in which your firm provides its opinion on the adequacy of consideration in a transaction.

- Providing the client advice on valuation methodologies and assumptions needed to perform the valuation
- Providing advice on valuation templates, software, or other tools that allow the client to determine an appropriate value for acquired assets, goodwill, contingent consideration, and so on

May My Firm Provide Investment Advisory Services to a Client?

Here are examples of what you and your firm may do under the AICPA rules:

- Make recommendations to a client about the allocation of funds to various asset classes
- Analyze investment performance

However, the AICPA rules also indicate that you and your firm may not do the following:

- Make investment decisions for the client
- Execute investment transactions
- Take custody of a client's assets

May My Firm Design or Implement an Information System for a Client?

Your firm may not design or develop a client's financial information system or make more than insignificant modifications to the source code underlying such a system. In addition, operating a client's local area network is prohibited.

Your firm may install an accounting software package for a client, including helping the client set up a chart of accounts and financial statement format. Your firm also may provide training to the client's employees on how to use an information system. Your firm may not, however, supervise the client's employees in their day-to-day use of the system because that activity is a management function.

Your firm is not precluded from designing, implementing, integrating, or installing an information system that is unrelated to the client's financial reporting process.[23]

SEC rules prohibit your firm from providing any service related to an SEC audit client's financial information system design or implementation unless the results of your firm's services would not be subject to audit procedures during an audit of the client's financial statements. Your firm may do either of the following:

- Evaluate internal controls of a financial information system as it is being designed, implemented, or operated for the client by another service provider
- Make recommendations on internal control matters to management in connection with a system design and implementation project being performed by another service provider

Note: If your audit client is an issuer, your firm must obtain preapproval for these and other internal control-related services, in accordance with PCAOB Rule 3525.

May My Firm Provide a Client With Training Services?

In February 2010, the staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of an FAQ) on the question of whether a member's independence would be impaired if he or she provided training to a client that is implementing changes to its financial reporting system or process. The FAQ concludes that a member's independence would not be impaired if the client personnel are provided with a general understanding of the financial reporting system or process. It goes on to explain that if client personnel already have a general understanding, the member may provide more specific training to client personnel on how the system or process applies to the client's specific circumstances. It cautions members that they should ensure that the training does not involve supervising client personnel in either the implementation or daily

[23] Frequently asked questions are available to assist members in understanding and implementing the new information technology services provisions and may be obtained at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.

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operation of the financial system or process or result in the member performing other management responsibilities, such as making operational decisions or implementing the internal controls necessary for the system or process to run effectively.

Fee Issues

What Types of Fee Arrangements Between My Firm and a Client Are Prohibited?

Two types of fee arrangements, contingent fees and commissions, are prohibited if the arrangement involves certain attest clients, even though the fee is not related to an attest service.

A *contingent fee* is an arrangement whereby (*a*) no fee is charged unless a specified result is attained or (*b*) the amount of the fee depends on the results of your firm's services. Some examples of contingent fees are the following:

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

The following are exceptions:

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

A *commission* is any compensation paid to you or your firm for (*a*) recommending or referring a third party's product or service to a client or (*b*) recommending or referring a client's product or service to a third party.

The following are examples of commissions:

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

Commissions or contingent fee arrangements with a client are not allowed if your firm also provides one of the following services to a client:

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

You may have commission and contingent fee arrangements with persons associated with a client—such as officers, directors, and principal shareholders—or with a benefit plan that is sponsored by a client (that is, the plan itself is not an attest client). For example, you may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer, and the officer purchases a policy. Even though this situation is permitted, you are still required to tell the officer that you received a commission for making the referral.

Note: State boards of accountancy and state societies also may have more restrictive regulations regarding fee arrangements, as well as specific disclosure requirements.

PCAOB Rule 3521, *Contingent Fees* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), prohibits you and your firm from providing any service or product to an SEC audit client for a contingent fee

or commission or receiving from the audit client, directly or indirectly, a contingent fee or commission. Although the PCAOB's definition of *contingent fees* was adapted from the SEC's definition, the PCAOB rule eliminated the exception for fees in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. In addition, the PCAOB rule specifically indicates that the contingent fees cannot be received directly or indirectly from an issuer that is an audit client.

When Are Referral Fees Permitted?

The AICPA rule provides an exception for referral fees for recommending or referring a CPA's services to another person or entity. That is, you may (*a*) receive a fee for referring a CPA's services to any person or entity or (*b*) if you are a CPA, you may pay a fee to obtain a client. You must inform the client if you receive or pay a referral fee.

Is Independence Affected When a Client Owes the Firm Fees for Professional Services That the Firm Has Already Provided?

If a client owes your firm fees for services rendered more than one year ago, your firm's independence is considered impaired. It does not matter if the fees are related to attest services; what matters is that the client has an outstanding debt with the firm. This is the case even if the client has given you a note receivable for these fees.

The SEC generally expects payment of past due fees before an engagement has begun, although a short-term payment plan may be accepted if the SEC audit client has committed to pay the balance in full before the current year report is issued.[24]

Does Being Compensated for Selling Certain Services to Clients Affect My Independence?

The AICPA rules do not specifically address this issue.

The SEC prohibits audit partners from being directly compensated for selling nonattest services to issuers that are audit clients. The SEC believes that such financial incentives could threaten an audit partner's objectivity and that the appearance of independence could be affected by such compensation arrangements.[25]

The rule does not prevent an audit partner from sharing in profits of the audit practice or the overall firm, nor does it preclude the firm from evaluating a partner based on factors related to the sale of nonaudit services to issuers (for example, the complexity of engagements or overall management of audit or nonaudit engagements).

Does It Matter if a Significant Proportion of My Firm's Fees Come From a Particular Client?

The conceptual framework states that a financial self-interest threat may exist due to "excessive reliance on revenue from a single attest client." In addition, Rule 102 and ET section 55, *Article IV—Objectivity and Independence* (AICPA, *Professional Standards*, vol. 2), discuss in broad terms that members should be alert for relationships that could diminish their objectivity and independence in performing attest services. The significance of a client to a member (or his or her firm)—measured in terms of fees, status, or other factors—may diminish a member's ability to be objective and maintain independence when performing attest services.

To address this issue, firms should consider implementing the following policies and procedures to identify and monitor significant clients to help mitigate possible threats to a member's objectivity and independence:

- Policies and procedures for identifying and monitoring significant client relationships, including the following:

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[24] The exception generally has been applied only to engagements to audit a client's financial statements included in its annual report, not in a registration statement.

[25] Accounting firms with 10 or fewer partners and 5 or fewer audit clients that are issuers, as defined by the SEC, are exempt from this rule.

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- — Considering client significance in the planning stage of the engagement.
- — Basing the consideration of client significance on firm-specific criteria or factors that are applied on a facts and circumstances basis (see the "Factors to Consider in Identifying Significant Clients" section that follows).
- — Periodically monitoring the relationship. What constitutes periodic is a matter of judgment, but assessments of client significance that are performed at least annually can be effective in monitoring the relationship. During the course of such a review, a client previously deemed to be significant may cease to be significant. Likewise, clients not identified as significant could become significant whenever factors that the firm considers relevant for identifying significant clients arise (for example, additional services are contemplated).

- Policies and procedures for helping mitigate possible threats to independence and objectivity, including the following:
  - — Assigning a second (or concurring) review partner who is not otherwise associated with the engagement and practices in an office other than those that perform the attest engagement.
  - — Subjecting the assignment of engagement personnel to approval by another partner or manager.
  - — Periodically rotating engagement partners.
  - — Subjecting significant client attest engagements to internal firm monitoring procedures.
  - — Subjecting significant client attest engagements to preissuance or postissuance reviews or the firm's external peer review process.

The most effective safeguards that a firm can employ will vary significantly, depending on the size of the firm; the way the firm is structured (for example, whether highly centralized or departmentalized); and other factors. For example, smaller firms (particularly those with one office) tend to be simpler and less departmentalized than larger firms. Generally, their processes will be less formal and involve fewer people than those of larger firms. Further, the firms' managing partners may engage in frequent and direct communications with the firms' partners and professional staff on client matters and be personally involved in staff assignments. Larger firms draw from a sizeable and diverse talent pool. In those firms, partners who are not affiliated with the engagement (or the client service office or business unit) can choose second (or concurring) review partners from outside the office performing the attest engagement. Midsized or regional firms may have aspects of both their smaller and larger counterparts, like combining the ability to choose second review partners from an office other than the client service office while maintaining a relatively close connection to specific client relationships.

Factors to Consider in Identifying Significant Clients

The following are both qualitative and quantitative factors that can reveal a significant client:

- The size of the client in terms of the percentage of fees or the dollar amount of fees versus total revenue of the engagement partner, office, or practice unit of the firm[26]
- The significance of the client to the engagement partner, office, or practice unit of the firm in light of the following:
  - — The amount of time the partner, office, or practice unit devotes to the engagement
  - — The effect on the partner's stature within the firm due to his or her relationships with the client
  - — The manner in which the partner, office, or practice unit is compensated
  - — The effect that losing the client would have on the partner, office, or practice unit

[26] Assessing client significance at the business or practice unit level may be a more meaningful measure for firms that structure their practices along industry lines (such as healthcare or financial services).

- The importance of the client to the firm's growth strategies (for example, the firm is trying to gain entry into a particular industry)
- The stature of the client, which may enhance the firm's stature (for example, the firm is trying to gain entry into a particular industry)
- Whether the firm also provides services to related parties (for example, also provides professional services to affiliates or owners of the client)
- Whether the engagement is recurring

Judgment is necessary to determine whether a client is significant to the firm, office, practice unit, or partner of the firm. Firms will vary considerably in terms of the degree to which they consider some factors to be more pertinent than others. Gauges that relate to each relevant level within a firm (for example, firm, geographic region, office, or practice unit) may be useful but likely will be different for various levels within the firm.

In general, if a firm derives more than 15 percent of its total revenues from one SEC audit client or group of related clients, independence may be impaired because this may cause the firm to be overly dependent on the client or group of related clients.

Further Assistance

Where Can I Find Further Assistance With My Independence Questions?

This appendix does not address many subjects included in the AICPA rules. Readers are encouraged to view the online version of the code at www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx.

In addition, readers should refer to ET section 100-1 in evaluating whether a specific circumstance that is not addressed in the code would pose an unacceptable threat to independence.

As specific services and situations arise in practice, refer to the independence literature and consult with those responsible for independence in your firm. If you need further assistance researching your question, contact one of the following organizations for guidance.

The AICPA has a variety of resources for practitioners:

- For information about the AICPA's ethics standard setting activities, see www.aicpa.org/INTERESTAREAS/PROFESSIONALETHICS/COMMUNITY/Pages/community.aspx.
- For questions related to understanding the nonattest services rules, consult the *Background and Basis for Conclusions* document for nonattest services at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsNonAttestServices.doc.
- For resources related to applying the nonattest services rules, see www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.
- The AICPA code is available at www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx.
- For independence inquiries by phone, call (888) 777-7077. Send e-mail inquiries to ethics@aicpa.org.
- The AICPA interactive CD-ROM course on independence, *Independence*, teaches the AICPA and SEC independence rules and qualifies for four hours of continuing professional education credits. See www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Ethics/PRDOVR~PC-739155HS/PC-739155HS.jsp.

SEC resources are as follows:

- The SEC's January 2003 rules release is available at www.sec.gov/rules/final/33-8183.htm.
- Information for accountants, including independence, may be found online at the Office of the Chief Accountant at www.sec.gov/about/offices/oca/ocaprof.htm.

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- Independence reference materials can be found on the SEC website at www.sec.gov/info/accountants/independref.shtml.
- U.S. Securities and Exchange Commission, Office of the Chief Accountant, 100 F Street, NE, Washington, DC 20549; (202) 551-5300 (phone); (202) 772-9252 (fax).

The PCAOB has a website at www.pcaobus.org. Standards and rules can be found at http://pcaobus.org/Standards/Pages/default.aspx.

GAO resources are as follows:

- Obtain the GAO Yellow Book requirements at www.gao.gov/aac.html.
- Obtain Yellow Book independence standards at www.gao.gov/govaud/govaudhtml/d07731g-5.html#pgfId-1034319.
- Obtain answers to FAQs on independence at www.gao.gov/govaud/d02870g.pdf.
- Access a slide presentation on GAO independence standards at www.gao.gov/govaud/july2007slides.pdf.
- Direct inquiries should be sent to Michael Hrapsky, Senior Project Manager, Government Auditing Standards, at (202) 512-9535 or e-mail yellowbook@gao.gov.

DOL resources are as follows:

- DOL Regulation 2509.75-9, *Interpretive Bulletin Relating to Guidelines on Independence of Accountant Retained by Employee Benefit Plan*. This regulation can be found at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=e46da7169dc9db98a57461c30d1115bf&rgn=div5&view=text&node=29:9.1.3.1.1&idno=29#29:9.1.3.1.1.0.10.9.
- Direct inquiries to the DOL at 1-866 4-USA-DOL.

Banking regulators' resources are as follows:

- Obtain the FDIC regulations (12 U.S. *Code of Federal Regulations* Part 363), *Annual Independent Audits and Reporting Requirements*, at www.fdic.gov/regulations/laws/rules/2000-8500.html#2000part363.
- The following organizations comprise the Federal Financial Institutions Examination Council (FFIEC): Office of Thrift Supervision, Treasury; Board of Governors of the Federal Reserve System; FDIC; National Credit Union Administration; and Office of the Comptroller of the Currency, Treasury. The FFIEC issues financial institution letters (FILs), which are addressed to the CEOs of the financial institutions on the FIL's distribution list—generally, FDIC-supervised institutions. FILs may announce new regulations and policies, new FDIC publications, and a variety of other matters of principal interest to those responsible for operating a bank or savings association. FILs have addressed auditor conduct (for example, internal audit outsourcing and use of indemnification clauses in engagement letters) in recent years and may apply to both public and nonpublic institutions. See http://search.fdic.gov/search?access=p&output=xml_no_dtd&sort=date:D:L:d1&site=fils&ie=UTF-8&btnG=Search&client=fils&oe=UTF-8&proxystylesheet=fils&q=auditor+independence&ip=69.113.123.203&filter=p for additional information.

International Federation of Accountants (IFAC) resources are as follows:

- Information about the International Ethics Standards Board for Accountants (IESBA) can be found on the IFAC's website at www.ifac.org/Ethics/.
- The IESBA's *Code of Ethics for Professional Accountants* can be found at http://web.ifac.org/media/publications/5/2010-handbook-of-the-code-o/2010-handbook-of-the-code-o.pdf.

[*The next page is 9000-211.*]

AAM Section 8290

Understanding the New Auditing Standards Related to Risk Assessment

NOTICE TO READERS
UNDERSTANDING THE NEW AUDITING STANDARDS RELATED TO RISK ASSESSMENT

This Audit Risk Alert is intended to provide auditors with an overview of the new risk assessment standards to be used in the planning and performance of a financial statement audit.

This publication is an *Other Auditing Publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an Other Auditing Publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Introduction

.01 This audit Alert provides a summary of eight Statements on Auditing Standards (SASs) that provide extensive guidance on how you should apply the audit risk model in the planning and performance of a financial statement audit. These SASs were issued in March 2006 and become effective for audits of financial statements for periods beginning on or after December 15, 2006. Earlier application is permitted. While the time period between the issuance and effective date of the standards may seem long, you should not underestimate the standards' significance and the far-reaching effect they will have on your audits.

.02 The eight SASs[1] consist of:

[1] Statements on Auditing Standards issued by the Auditing Standard Board are applicable to audits of privately held entities and other *nonissuers*. The term *issuer* means entities that are subject to the rules and regulations of the U.S. Securities and Exchange Commission and the Sarbanes-Oxley Act of 2002.

- SAS No. 104, *Amendment to Statement on Auditing Standards No. 1*, Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*
- SAS No. 105, *Amendment to Statement on Auditing Standards No. 95*, Generally Accepted Auditing Standards
- SAS No. 106, *Audit Evidence*
- SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*
- SAS No. 108, *Planning and Supervision*
- SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*
- SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*
- SAS No. 111, *Amendment to Statement on Auditing Standards No. 39*, Audit Sampling

.03 The Auditing Standards Board (ASB) believes that the SASs represent a significant strengthening of auditing standards that will improve the quality and effectiveness of audits. The primary objective of the SASs is to enhance your application of the audit risk model in practice by requiring, among other things:

- A more in-depth understanding of your audit client and its environment, including its internal control. This knowledge will be used to identify the risk of material misstatement in the financial statements (whether caused by error or fraud) and what the client is doing to mitigate them.
- A more rigorous assessment of the risk of material misstatement of the financial statements based on that understanding.
- Improved linkage between the assessed risks and the nature, timing, and extent of audit procedures performed in response to those risks.

.04 The development of these SASs was undertaken in response to recommendations to the ASB made by the former Public Oversight Board's Panel on Audit Effectiveness. In addition, the major corporate failures of the past several years have undermined the public's confidence in the effectiveness of audits and led to an intense scrutiny of the work of auditors, and the development of the SASs also have been influenced by these events.

How the Risk Assessment Standards Affect Current Practice

.05 The SASs incorporate many of the underlying concepts and detailed performance requirements that exist in the current standards. However, the SASs do create significant new requirements for auditors.

.06 In most cases, implementation of the SASs will result in an overall increased work effort by the audit team. It also is anticipated that, to implement the SASs appropriately, many firms will have to make significant revisions to their audit methodologies and train their personnel accordingly. To ease the implementation process, it is recommended that firms adopt at least some of the provisions of the standards in advance of the required implementation date.

How This Alert Is Organized

.07 This Alert is organized into three different parts.

- *Part One: Key Provisions of the SASs and How They Differ From Current Standards*. This part provides a summary of some of the key provisions of the SASs and how they differ, if at all, from current audit standards.

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- *Part Two: Fundamental Concepts*. This part summarizes the guidance in the SASs relating to fundamental audit concepts such as materiality, financial statement assertions, and audit evidence.
- *Part Three: Applying the Audit Risk Model*. This part of the Alert provides a summary of the application of the audit risk model as described by the SASs.

Part One: Key Provisions of the SASs and How They Differ From Current Standards

.08 This section discusses the key provisions of each of the SASs and provides a summary of how each of the SASs differs, if at all, from the current AICPA generally accepted audit standards.

SAS No. 104, *Amendment to Statement on Auditing Standards No. 1,* Codification of Auditing Standards and Procedures *("Due Professional Care in the Performance of Work")*

.09

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 104 defines *reasonable assurance* as a "high level of assurance."	• SAS No. 104 clarifies the meaning of reasonable assurance.

SAS No. 105, *Amendment to Statement on Auditing Standards No. 95,* Generally Accepted Auditing Standards

.10

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 105 expands the scope of the understanding that the auditor must obtain in the second standard of field work from "internal control" to "the entity and its environment, including its internal control." • The quality and depth of the understanding to be obtained is emphasized by amending its purpose from "planning the audit" to "assessing the risk of material misstatement of the financial statements whether due to error or fraud and to design the nature, timing, and extent of further audit procedures."	• Previous guidance considered the understanding of the entity to be a part of audit planning, and emphasized that the understanding of internal control also was primarily part of audit planning. • By stating that the purpose of your understanding of the entity and its internal control is part of assessing the risk of material misstatement, SAS No. 105 essentially considers this understanding to provide audit evidence that ultimately supports your opinion on the financial statements. • The new standard emphasizes the link between understanding the entity, assessing risks, and the design of further audit procedures. It is anticipated that "generic" audit programs will not be an appropriate response for all engagements because risks vary between entities.

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Key Provisions	*How the SAS Differs From Current Standards*
	• The term *further audit procedures*, which consists of test of controls and substantive tests, replaces the term *tests to be performed* in recognition that risk assessment procedures are also performed. • The term *audit evidence* replaces the term *evidential matter.*

SAS No. 106, *Audit Evidence*

.11

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 106 defines *audit evidence* as "all the information used by the auditor in arriving at the conclusions on which the audit opinion is based."	• Previous guidance did not define audit evidence. • SAS No. 106 also describes basic concepts of audit evidence. • The term *sufficient, appropriate audit evidence,* defined in SAS No. 106, replaces the term *sufficient, competent evidence.*
• SAS No. 106 recategorizes assertions by classes of transactions, account balances, and presentation and disclosure; expands the guidance related to presentation and disclosure; and describes how the auditor uses relevant assertions to assess risk and design audit procedures.	• SAS No. 106 recategorizes assertions to add clarity. • *Assertion relating to presentation and disclosure* has been expanded and includes a new assertion that information in disclosures should be "expressed clearly" (understandability).
• SAS No. 106 defines *relevant* assertions as those assertions that have a meaningful bearing on whether the account is fairly stated.	• The term *relevant assertions* is new, and it is used repeatedly throughout SAS No. 106.
• SAS No. 106 provides additional guidance on the reliability of various kinds of audit evidence.	• The previous standard included a discussion of the competence of evidential matter and how different types of audit evidence may provide more or less valid evidence. SAS No. 106 expands on this guidance.
• SAS No. 106 identifies "risk assessment procedures" as audit procedures performed on all audits to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement at the financial statement and relevant assertion levels.	• SAS No. 106 introduces the concept of risk assessment procedures, which are necessary to provide a basis for assessing the risk of material misstatement. The results of risk assessment procedures, along with the results of further audit procedures, provide audit evidence that ultimately supports the auditor's opinion on the financial statements.
• SAS No. 106 provides that evidence obtained by performing risk assessment procedures, as well as that obtained by performing tests of controls and substantive procedures, is part of the	

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Key Provisions	*How the SAS Differs From Current Standards*
evidence the auditor obtains to draw reasonable conclusions on which to base the audit opinion, although such evidence is not sufficient in and of itself to support the audit opinion.	
• SAS No. 106 describes the types of audit procedures that the auditor may use alone or in combination as risk assessment procedures, tests of controls, or substantive procedures, depending on the context in which they are applied by the auditor.	• Risk assessment procedures include: — Inquiries of management and others within the entity — Analytical procedures — Observation and inspection
• SAS No. 106 includes guidance on the uses and limitations of inquiry as an audit procedure.	• Inquiry alone is not sufficient to evaluate the design of internal control and to determine whether it has been implemented.

SAS No. 107, *Audit Risk and Materiality in Conducting an Audit*

.12

Key Provisions	*How the SAS Differs From Current Standards*
• The auditor must consider audit risk and must determine a materiality level for the financial statements taken as a whole for the purpose of: 1. Determining the extent and nature of risk assessment procedures. 2. Identifying and assessing the risk of material misstatement. 3. Determining the nature, timing, and extent of further audit procedures. 4. Evaluating whether the financial statements taken as a whole are presented fairly, in conformity with generally accepted accounting principles.	• Previous guidance said that auditors "should consider" audit risk and materiality for certain specified purposes. SASs state that the auditor "must" consider. • New guidance explicitly states that audit risk and materiality are used to identify and assess the risk of material misstatement.
• Combined assessment of inherent and control *risks* is termed the *risk of material misstatement*.	• SAS No. 107 consistently uses the term *risks of material misstatement*, which often is described as a combined assessment of inherent and control risk. However, auditors may make separate assessment of inherent risk and control risks.
• The auditor should assess the risk of material misstatement as a basis for further audit procedures. Although that risk assessment is a judgment rather than a precise measurement of risk, the auditor should have an appropriate basis for that assessment.	• SAS No. 107 states that the auditor should have and document an appropriate basis for the audit approach. • These two provisions of the risk assessment standards effectively eliminate the ability of the auditor to assess control risk "at the maximum"

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Key Provisions	*How the SAS Differs From Current Standards*
• Assessed risks and the basis for those assessments should be documented.	without having a basis for that assessment. In other words, you can no longer “default” to maximum control risk.
• The auditor must accumulate all known and likely misstatements identified during the audit, other than those that the auditor believes are trivial, and communicate them to the appropriate level of management.	• SAS No. 107 provides additional guidance on communicating misstatements to management. • The concept of not accumulating misstatements below a certain threshold is included in the previous standards, but the SAS No. 107 provides additional specific guidance on how to determine this threshold.
• The auditor should request management to respond appropriately when misstatements (known or likely) are identified during the audit.	• SAS No. 107 provides specific guidance regarding the appropriate auditor’s responses to the types of misstatements (known or likely) identified by the auditor.

SAS No. 108, *Planning and Supervision*

.13

Key Provisions	*How the SAS Differs From Current Standards*
SAS No. 108 provides guidance on: • Appointment of the independent auditor. • Establishing an understanding with the client. • Preliminary engagement activities. • The overall audit strategy. • The audit plan. • Determining the extent of involvement of professionals possessing specialized skills. • Using a professional possessing information technology (IT) skills to understand the effect of IT on the audit. • Additional considerations in initial audit engagements. • Supervision of assistants.	• Much of the guidance provided in SAS No. 108 has been consolidated from several existing standards. • However, SAS No. 108 provides new guidance on preliminary engagement activities, including the development of an overall audit strategy and an audit plan. — The overall audit strategy is what previously was commonly referred to as the audit approach. It is a broad approach to how the audit will be conducted, considering factors such as the scope of the engagement, deadlines for performing the audit and issuing the report, and recent financial reporting developments. — The audit plan is more detailed than the audit strategy and is commonly referred to as the audit program. The audit plan describes in detail the nature, timing, and extent of risk assessment and further audit procedures you perform in an audit. • SAS No. 108 states that you should obtain a written understanding with your client.

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SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*

.14

Key Provisions	*How the SAS Differs From Current Standards*
• SAS No. 109 describes audit procedures that the auditor should perform to obtain the understanding of the entity and its environment, including its internal control.	• The auditor should perform "risk assessment procedures" to gather information and gain an understanding of the entity and its environment. These procedures include inquiries, observation, inspection, and analytical procedures. Previous standards did not describe the procedures that should be performed to gain an understanding of the client. • Information about the entity may be provided by a variety of sources, including knowledge about the entity gathered in previous audits (provided certain conditions are met), and the results of client acceptance and continuance procedures. • SAS No. 109 also directs the auditor to perform a variety of risk assessment procedures, and it describes the limitations of inquiry.
• The audit team should discuss the susceptibility of the entity's financial statements to material misstatement.	• Previous standards did not require a "brainstorming" session to discuss the risk of material misstatements. SAS No. 109 requires such a brainstorming session, which is similar (and may be performed together with) the brainstorming session to discuss fraud.
• The purpose of obtaining an understanding of the entity and its environment, including its internal control, is to identify and assess "the risk of material misstatement" and design and perform further audit procedures responsive to the assessed risk.	• SAS No. 109 directly links the understanding of the entity and its internal control with the assessment of risk and design of further audit procedures. Thus, the understanding of the entity and its environment, including its internal control, provides the audit evidence necessary to support the auditor's assessment of risk.
• SAS No. 109 states the auditor should assess the risk of material misstatement at both the financial statement and relevant assertion levels.	• The previous standard included the concept of assessing risk at the financial statement level, but SAS No. 109 provides expanded and more explicit guidance. • SAS No. 109 also directs the auditor to determine how risks at the financial statement level may result in risks at the assertion level.
• SAS No. 109 provides directions on how to evaluate the design of the entity's controls and determine whether the controls are adequate and have been implemented.	• Under the previous standard, the primary purpose of gaining an understanding of internal control was to plan the audit. Under SAS No. 109, your understanding of internal control is used to assess risks. Thus, the

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Key Provisions	*How the SAS Differs From Current Standards*
	understanding of internal control provides audit evidence that ultimately supports the auditor's opinion on the financial statements. ● The previous standard directs the auditor to obtain an understanding of internal control as part of obtaining an understanding of the entity and its environment. SAS No. 109 requires auditors to evaluate the design of controls and determine whether they been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements. It is anticipated that this phase of the audit will require more work than simply gaining understanding of internal control.
● SAS No. 109 directs the auditor to consider whether any of the assessed risks are significant risks that require special audit consideration or risks for which substantive procedures alone do not provide sufficient appropriate audit evidence.	● Previous standard did not include the concept of "significant risks." ● Significant risks exist on most engagements. ● The auditor should gain an understanding of internal control and also perform substantive procedures for all identified significant risks. Substantive analytical procedures alone are not sufficient to test significant risks.
● SAS No. 109 provides extensive guidance on the matters that should be documented.	● The guidance provided by SAS No. 109 relating to documentation is significantly greater than that provided by previous standards. ● Part three of this Alert lists the documentation requirements of the SASs.

SAS No. 110, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*

.15

Key Provisions	*How the SAS Differs From Current Standards*
● SAS No. 110 provides guidance on determining overall responses to address the risk of material misstatement at the financial statement level and the nature of those responses.	● The concept of addressing the risk of material misstatement at the financial statement level and developing an appropriate overall response is similar to the requirement in previous standards relating to the consideration of audit risk at the financial statement level. However, that guidance was placed in the context of audit planning. SAS No. 110 "repositions" your consideration of risk at the financial statement level so you make this assessment as a result of and in

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Key Provisions	*How the SAS Differs From Current Standards*
	conjunction with your performance of risk assessment procedures. In some cases, this assessment may not be able to be made during audit planning. • SAS No. 110 requires you to consider how your assessment of risks at the financial statement level affect individual financial statement assertions, so that you may design and perform tailored further audit procedures (substantive tests or tests of controls). • The list of possible overall responses to the risk of material misstatement at the financial statement level also has been expanded.
• Further audit procedures, which may include tests of controls, or substantive procedures should be responsive to the assessed risk of material misstatement at the relevant assertion level.	• Although the previous standards included the concept that audit procedures should be responsive to assessed risks, this idea was embedded in the discussion of the audit risk model. The SASs repeatedly emphasize the need to provide a clear linkage between your understanding of the entity, your risk assessments, and the design of further audit procedures. • SAS No. 110 requires you to document the linkage between assessed risks and further audit procedures, which was not a requirement under the previous standards.
• SAS No. 110 provides guidance on matters the auditor should consider in determining the nature, timing, and extent of such audit procedures.	• The new guidance on determining the nature, timing, and extent of tests of controls and substantive tests has been expanded greatly and addresses issues that previously were not included in the authoritative literature. • SAS No. 110 states that the nature of further audit procedures is of most importance in responding to your assessed risk of material misstatement. That is, increasing the extent of your audit procedures will not compensate for procedures that do not address the specifically identified risks of misstatement. • SAS No. 110 states that you should perform certain substantive procedures on all engagements. These procedures include: — Performing substantive tests for all relevant assertion related to each material class of transactions, account balance, and disclosure regardless of the assessment of the risk of material misstatements.

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Key Provisions	How the SAS Differs From Current Standards
	— Agreeing the financial statements, including their accompanying notes, to the underlying accounting records — Examining material journal entries and other adjustments made during the course of preparing the financial statements

SAS No. 111, *Amendment to Statement on Auditing Standards No. 39,* Audit Sampling

.16

Key Provisions	*How the SAS Differs from Current Standards*
• SAS No. 111 provides guidance relating to the auditor's judgment about establishing tolerable misstatement for a specific audit procedure and on the application of sampling to tests of controls.	• SAS No. 111 provides enhanced guidance on tolerable misstatement. In general, tolerable misstatement in an account should be less than materiality to allow for aggregation in final assessment.

Part Two: Fundamental Concepts

.17 The SASs describe a process for applying the audit risk model to gather audit evidence and form an opinion about your client's financial statements. To apply this process appropriately, you will need to have a working knowledge of the key concepts upon which it is built. Those concepts include the following.

- The meaning of *reasonable assurance*
- Audit risk and the risk of material misstatement
- Materiality and tolerable misstatement
- Financial statement assertions
- Internal control
- Information technology
- Audit evidence

.18 This part of the Alert provides a summary of these key concepts and a description of how they are used.

Reasonable Assurance

.19 The auditing standards make numerous references to your responsibility for obtaining "reasonable assurance." For example, your audit opinion states that generally accepted auditing standards require you to "obtain reasonable assurance about whether the financial statements are free of material misstatement." "Reasonable assurance" is the fundamental threshold you use to design and perform your audit procedures. For this reason, it is important that you have a working knowledge of the term.

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.20 SAS No. 104 clarifies that reasonable assurance is a high, but not absolute, level of assurance. Put another way, you must plan and perform your audit in such a way to obtain sufficient appropriate audit evidence to reduce audit risk to a low level. Although "reasonable assurance" is a high level of assurance, it is not absolute assurance. Absolute level of assurance is not attainable because an auditor does not examine 100 percent of the entity's transactions or events and because of the limitations of the entity's internal control.

Audit Risk and the Risk of Material Misstatement

.21 Audit risk (AR) is the risk that the financial statements are materially misstated and you fail to detect such a misstatement or appropriately modify your opinion. You should perform your audit to reduce audit risk to a low level. You need to consider audit risk at all stages of your audit.

.22 Audit risk is a function of two components:

1. *Risk of material misstatement (RMM)*, which is the risk that an account or disclosure item contains a material misstatement. The risk of material misstatement is a combination of inherent and control risk.

2. *Detection risk*, which is the risk that you will not detect such misstatements in an account or disclosure item.

.23 Reducing audit risk to a low level requires you to:

1. Assess the risk of material misstatement.

2. Based on that assessment, design and perform further audit procedures to reduce audit risk to an appropriate low level.

Assessing the Risk of Material Misstatement

.24 The risk of material misstatement exists independently of detection risk. Many factors affect the risk of material misstatement, including the following.

- The client's industry, its regulatory environment, and other external factors
- The nature of the entity, for example, its operations, ownership, and financing
- The client's objectives, strategies, and related business risks
- How client management measures and reviews the company's financial performance
- The client's internal control, which includes the selection and application of accounting policies

Thus, the first step in assessing the risk of material misstatement is to gather information and gain an understanding of these and other items that create risks. Part Three of this Alert describes an audit process that begins with your gaining an understanding of these matters.

.25 The risk of material misstatement may reside at either the financial statement level or the assertion level.

- *Financial statement-level risks* potentially affect many different assertions. For example, a lack of qualified personnel in financial reporting roles (an element of the client's control environment) may affect many different accounts and several assertions.

- *Assertion-level risks* are limited to a single assertion, for example, the valuation of inventory or the occurrence of sales.

.26 Your response to assessed risks will differ depending on whether they reside at the financial statement or assertion level.

- Financial statement-level risks typically require an overall response, such as providing more supervision to the engagement team or incorporating additional elements of unpredictability in the selection of your audit procedures.
- Assertion-level risks are addressed by the nature, timing, and extent of further audit procedures.

For this reason, you should assess the risk of material misstatement at both the financial statement and the assertion level.

.27 Your assessment of the risk of material misstatement (at both the financial statement and the assertion level) should be directly linked to the design and performance of further audit procedures. For example, if your understanding of the client, its environment, and its internal control lead you to assess that there is a high inherent risk that inventory quantities could be misstated, you would design tailored further audit procedures to specifically respond to that risk.

.28 To perform audit procedures that are appropriately responsive to your assessed risks, you should define these risks in a way that incorporates the unique circumstances at the client. Generic checklists and standard audit programs may serve as a starting point for helping you to understand and assess risk, but to be truly effective, these generic audit tools need to be tailored to the specific circumstances of your client.

.29 The process for applying the audit risk model, which is summarized in Part Three of this Alert, describes in more detail how you should link your assessment of risk to the design and performance of further audit procedures.

.30 ***Risks of Material Misstatement at the Assertion Level.*** At the assertion level, the risk of material misstatement consists of two components:

- *Inherent risk (IR),* which is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. Inherent risk is greater for some assertions and related account balances, classes of transactions, and disclosures than for others.
- *Control risk (CR)*, which is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely basis by the client's internal control. Control risk is a function of the effectiveness of the design and operation of the client's internal control.

Detection Risk

.31 Detection risk is the risk that you will not detect a material misstatement that exists in an assertion. It is a function of the nature, timing, and effectiveness of audit procedures and how you apply them.

.32 Detection risk relates to your substantive audit procedures and is managed by how you respond to the risk of material misstatement at both the financial statement and the assertion level.

- *Financial statement-level risks.* Your responses to financial statement-level risks may include assignment of more experienced personnel to the engagement team, emphasizing of the application of professional skepticism, and providing more supervision and review of the audit work performed. Appropriate choices related to these matters will help you mitigate the risks that you might select an inappropriate audit procedure, misapply audit procedures, or misinterpret the results.
- *Assertion-level risks.* In response to assertion-level risks you will determine the nature, timing, and extent of your further audit procedures that are appropriate to respond to the assessed risk.

Thus, the effectiveness of further audit procedures depends on whether you have:

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1. Acquired a sufficient depth and breadth of understanding of your client to make an informed assessment of the risk of material misstatements.

2. Used your assessment of the risks of material misstatement to drive the nature, timing, and extent of your further audit procedures.

.33 ***An Inverse Relationship Between the Risk of Material Misstatement and Detection Risk.*** At the assertion level, detection risk has an inverse relationship to the risk of material misstatement. The greater the risk of material misstatement, the less the detection risk that you should be willing to accept. Put another way, the greater the risk of material misstatement, the more reliable your substantive tests should be.

.34 Conversely, when the risk of material misstatement is low, you can accept a greater level of detection risk. However, you are always required to perform substantive tests on all relevant assertions related to each material account balance, class of transactions, and disclosure, regardless of your assessment of the risk of material misstatement.

.35 The model AR = RMM x DR expresses the general relationship of audit risk and its components. You may find this model useful when planning appropriate risk levels for your audit procedures, keeping in mind your overall desire to reduce audit risk to an appropriate low level.

Materiality and Tolerable Misstatement

The Concept of Materiality

.36 The concept of materiality recognizes that some matters are more important for the fair presentation of the financial statements than are others. In performing your audit, you are concerned with matters that could be material to the financial statements. Your responsibility is to plan and perform the audit to obtain reasonable assurance that material misstatements, whether caused by error or fraud, are detected.

.37 Financial Accounting Standards Board Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, defines *materiality* as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed by the omission or misstatement." Thus, materiality is influenced by your perception of the needs of financial statement users who will rely on the financial statements to make judgments about your client's financial position and results of operations.

How Materiality Is Used in Your Audit

.38 Though defined by the accounting literature, materiality also is an audit concept of critical importance. Audit materiality represents the maximum amount that you believe the financial statements could be misstated and still fairly present the client's financial position and results of operations. Audit materiality affects:

1. *The nature, timing, and extent of audit procedures.* During audit planning, you should determine a materiality level for the financial statements taken as a whole. This initial determination of materiality will help you:

   — Make judgments when identifying and assessing the risk of material misstatement

   — Determine the nature, timing, and extent of your further audit procedures

2. *The evaluation of audit findings.* To form an opinion about the financial statements, you must evaluate audit findings and determine whether the misstatements that are not corrected by the client, individually or in the aggregate, are material to the financial statements.

Quantitative and Qualitative Considerations

.39 Although materiality commonly is expressed in quantitative terms, your determination of materiality is a matter of professional judgment that includes both quantitative and qualitative considerations. During the course of your audit, you should be alert for misstatements that could be qualitatively material. However, it ordinarily is not practical to design audit procedures to detect misstatements that qualitatively are material, and for that reason, materiality used for planning purposes considers primarily quantitative matters.

Tolerable Misstatement

.40 During audit planning you must determine an initial level of materiality for the purposes of designing and performing your audit procedures. This initial determination of materiality is determined for the financial statements taken as a whole. However, in designing your audit procedures, you should take into account the possibility that several misstatements of amounts less than financial statement materiality could—in the aggregate—result in a material misstatement of the financial statements. That is, errors in an account or disclosure may still exist and your audit procedures may fail to detect them. For that reason, you need to allow for these undetected misstatements that may exist. You build this allowance into the overall audit strategy process by setting tolerable misstatement.

.41 Tolerable misstatement (also referred to as tolerable error) is defined as the maximum error in a population (for example, the class of transactions or account balance) that you are willing to accept. Tolerable misstatement normally is lower than materiality for the financial statements as a whole. For each class of transactions, account balance, and disclosure, you should determine at least one level of tolerable misstatement.

.42 For example, if for planning purposes you determined materiality to be $100,000, you could set tolerable misstatement at $60,000. Then, you would use this tolerable misstatement level to determine the nature, timing, and extent of your further audit procedures. You could use different levels of tolerable misstatement for other account balances, classes of transactions, or assertions. See AU section 350, *Audit Sampling*, of volume 1 of the AICPA *Professional Standards* for more guidance about tolerable misstatement.

Financial Statement Assertions

Why Financial Statement Assertions Are Important

.43 Your audit results in an opinion of the financial statements taken as a whole. However, to reach this opinion of the financial statements, most of your audit procedures should be directed at a much more detailed level, the assertion level.

.44 Assertions are management's implicit or explicit representations regarding the recognition, measurement, presentation, and disclosure of information in the financial statements and related disclosures. Assertions fall into three categories: (1) classes of transactions, (2) account balances, and (3) presentation and disclosure.

.45 For example, by presenting the information "Cash . . . .$XXX" in the financial statements, management implies that:

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- The cash truly exists and company has the right to use it.
- The amount presented represents all the company's cash.
- The amount presented is accurate.

.46 Many of your audit procedures are performed not on the financial statements taken as a whole nor even at the account or disclosure level, but rather, they are directed at individual assertions.

.47 Relating identified risks of material misstatement to misstatements that might occur at the assertion level is necessary for you to properly link assessed risks to further audit procedures.

.48 The table titled "Categories of Assertions" provides a summary of how assertions might be grouped into various categories. You may express these assertions differently, as long as your descriptions encompass all the aspects described in the table.

Categories of Assertions

	Description of Assertions		
	Classes of Transactions and Events During the Period	*Account Balances at the End of the Period*	*Presentation and Disclosure*
Occurrence/Existence	Transactions and events that have been recorded have occurred and pertain to the entity.	Assets, liabilities, and equity interests exist.	Disclosed events and transactions have occurred and pertain to the entity.
Rights and Obligations	—	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.	
Completeness	All transactions and events that should have been recorded have been recorded.	All assets, liabilities, and equity interests that should have been recorded have been recorded.	All disclosures that should have been included in the financial statements have been included.
Accuracy/Valuation and Allocation	Amounts and other data relating to recorded transactions and events have been recorded appropriately.	Assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are recorded appropriately.	Financial and other information is disclosed fairly and at appropriate amounts.
Cut-off	Transactions and events have been recorded in the correct accounting period.	—	—
Classification and Understandability	Transactions and events have been recorded in the proper accounts.	—	Financial information is appropriately presented and described and information in disclosures is expressed clearly.

How You Use Assertions in Your Audit

.49 Most of your tests of controls and substantive audit procedures are directed at specific assertions. For example, confirmation of receivables provides strong, direct evidence about the existence of those receivables

and it may provide some evidence about accuracy of the gross balance. However, confirmations alone are not sufficient appropriate audit evidence to test the valuation of receivables, and the auditor should perform other appropriate procedures, such as looking at subsequent cash receipts and applying analytical procedures in testing the allowance for doubtful accounts. For this reason, to establish a clear link between your assessment of the risk of material misstatement and further audit procedures, your risk assessment procedures should be performed at the assertion level as well.

Internal Control

Definition and Description of Internal Control

.50 Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives. These objectives fall into three categories: financial reporting, operations, and compliance with laws and regulations. In general, when performing a financial statement audit, you are most concerned with the client's financial reporting objectives, which relate to the preparation of audited financial statements.

.51 In trying to achieve its objectives, your client faces certain risks. Internal control helps the entity achieve its objectives by mitigating the risk of "what can go wrong" in the pursuit of its objectives. Thus, there is a direct link between the entity's objectives, the risks to achieving those objectives, and internal control. Your assessment of internal control is a consideration of whether the controls mitigate financial reporting risks.

.52 Internal control consists of five interrelated components:

1. *Control environment* sets the tone of an organization, influencing the control-consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure.

2. Entity's *risk assessment* is the entity's identification and analysis of relevant risks to achievement of its objectives, forming a basis for determining how the risks should be managed.

3. *Information and communication systems* support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities.

4. *Control activities* are the policies and procedures that help ensure that management directives are carried out.

5. *Monitoring* is a process that assesses the quality of internal control performance over time.

.53 This division of internal control into five components provides a useful framework for you to consider how different aspects of your client's internal control may affect your audit. You are not required to classify controls into a particular component. Rather, your understanding of internal control involves determining whether and how a specific control may prevent or detect and correct material misstatements.

Controls May Be Pervasive to the Entity or Restricted to an Account or Assertion

.54 Your client's financial reporting risks (and therefore its controls) may relate to one of the following:

1. To specific classes of transactions, account balances, and disclosures

2. More pervasively to the financial statements taken as a whole (And potentially the risks may affect many assertions.)

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.55 For example, a weak control environment potentially affects many assertions and therefore is considered to operate at the financial statement level. In contrast, a control to ensure that all valid purchases are captured and recorded is restricted to specific accounts and classes of transactions and thus operates at the assertion level.

.56 Understanding whether a control is restricted to specific classes of transactions, account balances, or disclosures or pertains pervasively to the financial statements will help you:

1. Design appropriate audit procedures to obtain information about the design of the control and whether it has been placed in operation

2. Assess the risk of material misstatement in the financial statements

3. Design substantive audit procedures

4. Assess the results of the tests of operating effectiveness of controls, if any

Control Design

.57 The evaluation of internal control design involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting material misstatements.

.58 On every audit you should evaluate the design of internal control and determine whether controls have been implemented over all relevant assertions related to each material account balance, class of transactions, or disclosures.

Control Operations

.59 The concept of the effective operation of controls is different from their design and implementation. The operating effectiveness of controls involves the consideration of:

— How controls were applied during the audit period

— The consistency with which they were applied

— By whom they were applied

.60 To assess the operating effectiveness of controls, you should perform tests of controls. Unlike the evaluation of control design, tests of controls are not required on every audit, only on those audits where the auditor's risk assessment procedures includes an expectation that the controls will be effective or when substantive procedures alone do not provide sufficient audit evidence at the assertion level.

Information Technology

.61 Your understanding of the client and its environment, including its internal control, includes an understanding of how it uses information technology (IT). A client's use of IT may affect any of the five components of internal control relevant to the achievement of the entity's financial reporting, operations, compliance objectives, and its operating units or business functions. Examples in which IT affects the entity and its environment are as follows.

- *External factors.* For example, technological innovations may have lowered the barriers to entry into the client's industry, which in turn increases competition not only for customers, but perhaps also for raw materials or qualified personnel.

- *Client operations.* For example, your client's manufacturing process may rely more on manual processes and less on technology than its competitors. Consequently, your client's financial and nonfinancial ratios will differ from others in the industry.
- *Objectives, strategies, and business risks.* For example, your not-for-profit client's innovative use of technology may allow it to raise contributions from groups of supporters who otherwise would not contribute to the organization.
- *Measurement and review of the client's financial performance.* For example, management frequently relies on information produced by the company's IT processing system to measure and review the company's financial performance. Management's ability to make decisions appropriately may rely on the accuracy, availability, and timeliness of the information processed by the IT system.

.62 The way in which IT is deployed may vary among entities. For example, your client may use IT as part of discrete systems that support only particular business units, functions, or activities, such as a unique accounts receivable system for a particular business unit or a system that controls the operation of factory equipment. Alternatively, other entities in the same industry may have complex, highly integrated systems that share data and that are used to support all aspects of the company.

Implications of IT on Your Understanding of Internal Control

.63 The nature and characteristics of your client's use of IT in its financial information system affect its internal control. For example:

- Multiple users may access a common database of information. In such circumstances, a lack of control at a single user entry point might compromise the security of the entire database, potentially resulting in improper changes to or destruction of data.
- When IT personnel or users are given, or can gain, access privileges beyond those necessary to perform their assigned duties, a breakdown in segregation of duties can occur. This breakdown could result in unauthorized transactions or changes to programs or data that affect the financial statements.

.64 ***General vs. IT Application Controls.*** IT general computer controls are polices and procedures that relate to many applications and support the effective functioning and continued proper operation of information systems. For example, your client's administration of passwords can potentially affect many applications. If passwords for a given user can be stored on that person's computer, the effectiveness of internal control may be compromised because anyone who gained access to the computer could inappropriately gain access to the application, the related data, or both.

.65 Other IT controls are applied only to specific applications, for example accounts payable, payroll, or the general accounting application. Application controls apply to the processing of individual applications. These controls help ensure that transactions occurred, are authorized, and are completely and accurately recorded and processed. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and performing manual follow-ups of exception reports.

How the Client's Use of IT Affects Audit Planning

.66 The use of professionals possessing IT skills is a significant aspect of many audit engagements. An IT professional may help:

- Determine the effect of IT on the audit
- Identify and assess IT risks

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- Understand IT controls
- Design and perform tests of IT controls or substantive procedures

.67 In determining whether an IT professional is needed on the audit team, you should consider factors such as the following:

- The complexity of the entity's systems and IT controls and the manner in which they are used in conducting the entity's business
- The significance of changes made to existing systems, or the implementation of new systems
- The extent to which data is shared among systems
- The extent of the entity's participation in electronic commerce
- The entity's use of emerging technologies
- The significance of audit evidence that is available only in electronic form

.68 Audit procedures that you may assign to a professional possessing IT skills include:

- Inquiring of the client's IT personnel how data and transactions are initiated, authorized, recorded, processed, and reported and how IT controls are designed
- Inspecting systems documentation
- Observing the operation of IT controls
- Planning and performing tests of IT controls

.69 If the use of an IT professional is planned, you should determine whether that professional is effectively functioning as a member of the audit team. If such a professional is part of your audit team, your responsibilities with respect to that professional are equivalent to those for other assistants. In such circumstances, you should have sufficient knowledge of IT matters to:

1. Communicate the objectives of the IT professional's work
2. Evaluate whether the specified audit procedures will meet your objectives
3. Evaluate the results of the audit procedures applied as they relate to the nature, timing, and extent of further planned audit procedures

Audit Evidence

The Nature of Audit Evidence

.70 Audit evidence is all the information you use to arrive at the conclusions that support your audit opinion. Audit evidence is cumulative in nature. For example, your evidence regarding payables begins with you performing risk assessment procedures relating to the client and its environment, including its internal control. These risk assessment procedures provide audit evidence to support your conclusion about the risk of material misstatement for payables. Based on this risk assessment, you then perform further audit procedures, which include substantive tests and may include tests of controls. The results of these further audit procedures provide audit evidence that, when considered in conjunction with the evidence from risk

assessment procedures, allow you to form a supportable conclusion about payables. You then repeat this process for other accounts, classes of transactions, and disclosures, and the aggregation of your conclusions provides a basis for your opinion on the financial statements taken as a whole.

.71 The procedures that you perform on your audit provide audit evidence, but they are not the only source of audit evidence. For example, previous audits and your firm's client acceptance and continuance procedures also may be sources of audit evidence.

.72 To determine whether you have obtained persuasive audit evidence, you should consider:

- The consistency of that evidence
- Whether the evidence was obtained from different sources or the performance of procedures that were of a different nature

.73 A lack of consistency among individual items of audit evidence may indicate that one of the items is not reliable. For example, in a not-for-profit entity, the board of trustees' minutes reported that all of the contributions received during the year were unrestricted, but some of the donor agreements examined by you stated that the contributions are temporarily restricted. When audit evidence obtained from one source is inconsistent with that obtained from another, you should determine what additional audit procedures are necessary to resolve the inconsistency.

.74 Ordinarily, you obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of evidence considered individually. For example, reading minutes of the board and other documentation and making inquiries of several individuals about matters included in disclosures usually provide more reliable evidence than does making inquiries of one individual.

The Sufficiency and Appropriateness of Audit Evidence

.75 ***Sufficiency of Audit Evidence.*** The sufficiency of audit evidence relates to its quantity. For example, the auditor who tests eight of the twelve monthly reconciliations between a general ledger control account and the related subsidiary ledger will obtain more evidence about the operating effectiveness of the control than the auditor who tests only two of the twelve reconciliations.

.76 The sufficiency of audit evidence you need to support your conclusion is affected by:

- *The risk of misstatement.* The greater the risk, the more audit evidence likely to be required to support a conclusion
- *The quality of the audit evidence obtained.* The higher the quality of the evidence, the less that will be required.

.77 ***Appropriateness of Audit Evidence.*** The appropriateness of audit evidence relates to its quality. The quality of audit evidence is a function of its relevance and its reliability in providing support, or detecting misstatements, in the accounts, classes of transactions, or assertions.

- *Relevance of audit evidence.* The results of your audit procedures may provide audit evidence that is relevant to certain assertions but not others. For example, tests of controls related to the proper authorization of a transaction will provide evidence about the occurrence assertion but not about the completeness assertion. Obtaining audit evidence relating to a particular assertion, in this example, the occurrence of a transaction, is not a substitute for obtaining audit evidence regarding another assertion, in this example, completeness.
- *Reliability of audit evidence.* The reliability of audit evidence is influenced by its source and by its nature. Reliability also depends on the individual circumstances under which it is obtained, including its timing.

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.78 Generalizations about the reliability of various kinds of audit evidence can be made; however, when considering such generalizations keep in mind that they are subject to important exceptions. Even when audit evidence is obtained from sources external to the client, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence may be useful.

- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence is more reliable when it exists in documentary form (whether paper, electronic, or other medium). For example, minutes of an audit committee meeting are more reliable than a subsequent oral representation of the matters discussed at the meeting.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

.79 Typically, you obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. For example, if the company lacks documentation to support its intent with regard to equity securities (which affect how those securities are classified and presented in the financial statements), you may have no choice but to rely on management's representations regarding their intent. Management's representations may be less reliable than a written record, but if you obtain representations from several sources (for example, from different members of management) and these representations are consistent with the client's past history of selling equity investments, then you may find the consistency of the evidence from different sources to be persuasive.

.80 An increased quantity of audit evidence may compensate for less reliable audit evidence, it cannot compensate for audit evidence that lacks relevancy. For example, a confirmation of an accounts receivable balance is not relevant to the valuation of the allowance account. Increasing the number of receivables confirmations will not provide you with any additional evidence relating to the allowance for doubtful accounts.

.81 ***Determining Whether You Have Obtained Sufficient, Appropriate Audit Evidence.*** You may find it necessary to rely on audit evidence that is persuasive rather than conclusive. However, to obtain the reasonable assurance required to support an opinion about the financial statements, you must not be satisfied with audit evidence that is less than persuasive.

Part Three: Applying the Audit Risk Model

.82 This part of the Alert provides a summary of the audit process. Even though some requirements and guidance are presented in a way that suggests a sequential process, audit fieldwork involves a continuous process of gathering, updating, and analyzing information throughout the audit.

.83 The following is an overview of how an auditor should apply the audit risk model in practice.

- *Gather information about the entity and its environment, including internal control.* Your first step in the process is to gather information about those aspects of the client and its environment that will allow you to identify and assess risks. Evaluating the design of the client's controls and determining whether they have been implemented are an integral part of this process.

- *Understand the entity and its environment, including its internal control.* Based on the information gathered, you should be able to identify what could go wrong in specific relevant assertions related to each account balance, class of transactions, or disclosures.
- *Assess the risk of material misstatement.* Next, you will use your understanding of the client and its environment, including its internal control, to assess the risk of material misstatement that relate to both financial statement level and specific assertions. To assess risks you will need to:
  - Identify the risk of material misstatement
  - Describe the identified risks in terms of what can go wrong in specific assertions
  - Consider the significance and likelihood of material misstatement for each identified risk
- *Design overall responses and further audit procedures.* You should address the risk of material misstatement at both the financial statement and the relevant assertion level.
  - The risk of material misstatement at the financial statement level has a more pervasive effect on the financial statements and affects many assertions. In addition to developing assertion-specific responses, financial statement-level risks may require you to develop an overall, audit-wide response, such as assigning more experienced audit team members.
  - Assertion-level risks pertain to a single assertion and should be considered when you design and subsequently perform further audit procedures. Depending on the results of your risk assessment procedures, further audit procedures may encompass a combined approach using both tests of controls and substantive procedures or a substantive audit approach. Either approach is directed at relevant assertions related to each material account balance, class of transactions, and disclosures. However, regardless of your assessment of risks, you need to perform substantive audit procedures on all relevant assertions related to each material account balance, class of transaction, or disclosure.

Information Gathering

Information Needed About the Client and Its Environment to Identify and Assess the Risk of Material Misstatement

.84 Obtaining an understanding of your client and its environment is an essential part of every audit. Not only does this understanding allow you to identify and assess the risk of material misstatement, it also allows you to exercise informed judgment about other audit matters such as:

- Materiality
- Whether the client's selection and application of accounting policies are appropriate and financial statement disclosures are adequate
- Areas where special audit consideration may be necessary, for example, related party transactions
- The expectation of recorded amounts that you develop for performing analytical procedures
- The design and performance of further audit procedures
- The evaluation of audit evidence

.85 Not all information about a client or its environment is relevant for your audit. In general, the information you should gather about your client is that which allows you to assess the risk that specific assertions could be materially misstated. The following table summarizes the various categories of information you should obtain about your client.

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Understanding the Client and Its Environment

On every audit you are required to gather information and obtain an understanding of the client and its environment. This understanding consists of the following aspects.

- *External factors*, including
  - — Industry factors such as the competitive environment, supplier and customer relationships, and technological developments.
  - — The regulatory environment, which includes relevant accounting pronouncements, the legal and political environment, and environmental requirements that affect the industry.
  - — Other matters such as general economic conditions.
- *Nature of the client*, which includes its operations, its ownership, governance, the types of investments it makes and plans to make, how it isfinanced, and how it is structured.
- *Objectives and strategies and related business risks*, which may result in material misstatement of the financial statements taken as a whole or individual assertions.
- *Measurement and review of the client's financial performance*, which tells you which aspects of the client's performance that management considers to be important.
- *Internal control*, which consists of five components: the control environment, risk assessment, information and communication, control activities, and monitoring. These components may operate at the entity level or the individual transaction level. To obtain an appropriate understanding of internal control will require you to understand and evaluate the design of all five components of internal control and to determine whether the controls are in use by the client.

Risk Assessment Procedures

.86 The audit procedures you perform to obtain an understanding of the entity and its internal control are referred to as *risk assessment procedures*. Some of the information you obtain by performing risk assessment procedures you will use to support your assessments of the risks of material misstatement. Risk assessment procedures include:

1. Inquiries of management and others at the client
2. Analytical procedures
3. Observation and inspection

.87 You need to gather audit evidence to support your assessment of the risk of material misstatement. It is not acceptable to simply deem control risk to be "at the maximum" without support. Your risk assessment procedures provide the audit evidence necessary to support your risk assessments, which in turn, support your determination of the nature, timing, and extent of further audit procedures. Thus, the results of your risk assessment procedures are an integral part of the audit evidence you obtain to support your opinion on the financial statements.

.88 ***A Mix of Procedures.*** Except for internal control, you are not required to perform all the procedures for each of the five aspects of the client and its environment discussed previously. However, in the course of gathering information about the client, you should perform all the risk assessment procedures.

.89 With regard to obtaining an understanding about the design of internal control and determining whether they have been implemented, inquiry alone is not sufficient. Thus, for these purposes, you should supplement your inquiries with other risk assessment procedures.

.90 ***Other Procedures That Provide Relevant Information About the Client.*** Following include some procedures you might consider.

- *Assessing the Risk of Material Misstatement Due to Fraud.* AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), directs you to perform certain audit procedures to assess the risk of material misstatement due to fraud. Some of these procedures also may help gather information about the entity and its environment, particularly its internal control. For this reason, you should:
  - — Coordinate the procedures you perform to assess the risk of material misstatement due to fraud with your other risk assessment procedures
  - — Consider the results of your assessment of fraud risk when identifying the risk of material misstatement
- *Other Information.* When relevant to the audit, you also should consider other knowledge you have of the client that can help you assess risk. This other information may include:
  - — Information obtained from your client acceptance or continuance process
  - — Experience gained on other engagements performed for the entity

.91 ***Updating Information From Prior Periods.*** If certain conditions are met, you may use information about the client you obtained in prior periods as audit evidence in the current period audit. However, when you intend to use information from prior periods in the current period audit, you should determine whether changes have occurred that may affect the relevance of the information for the current audit. To make this determination, you should make inquiries and perform other appropriate audit procedures, such as walk-throughs of systems.

Gaining an Understanding of the Client and Its Environment

.92 The gathering of information, by itself, does not provide you with the understanding of the client that is necessary for you to assess risk. For you to assess the risk of material misstatement and perform further audit procedures, you need to synthesize the information gathered to determine how it might affect the financial statements. For example:

- Information about the client's industry may allow you to identify characteristics of the industry that could give rise to specific misstatements. For example, if your client is a construction contractor that uses long-term contract accounting, your understanding of the client should be sufficient to allow you to recognize that the significant estimates of revenues and costs create a risk of material misstatement.
- Information about the ownership of your client, how it is structured, and other elements of its nature will help you identify related party transactions that, if not properly accounted for and adequately disclosed, could lead to a material misstatement.
- Your identification and understanding of the business risks facing your client increase the chance that you will identify financial reporting risks. For example, your client may face a risk that a new company may enter its market, and that new entrant could have certain business advantages (for example, economies of scale or greater brand recognition). The potential risk of material misstatement of the financial statements related to this business risk might be obsolescence or overproduction of inventory that could only be sold at a discount.
- Information about the performance measures used by client management may lead you to identify pressures or incentives that could motivate client personnel to misstate the financial statements.
- Information about the design and implementation of internal control may lead you to identify deficiencies in control design, which increase the risk of material misstatement.

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Evaluating the Design of Internal Control

.93 A sufficient understanding of internal control is one that allows you to evaluate the design of internal control and to determine whether controls have been placed in operation. This threshold describes a substantial understanding of internal control.

Requirements for Evaluating Control Design

.94 On every audit, you should obtain an understanding of internal control that is of sufficient depth to enable you to:

1. Assess the risks of material misstatement of the financial statements, whether due to error or fraud
2. Design the nature, timing, and extent of further audit procedures

.95 To meet this threshold of sufficiency, at both the entity and relevant assertion level, you should:

1. Evaluate the design of controls that are relevant to the audit and determine whether the control—either individually or in combination—is capable of effectively preventing or detecting and correcting material misstatements.
2. Determine that the control has been implemented, that is, that the control exists and that the entity is using it.

.96 Your evaluation of internal control design and the determination of whether controls have been implemented are critical to your assessment of the risks of material misstatement. It is not possible to develop a reliable assessment of the risk of material misstatement absent a sufficient understanding of internal control. For this reason, you are required to perform risk assessment procedures to gather information and form an understanding of internal control on every audit. Even if your initial audit strategy contemplates performing only substantive procedures for all relevant assertions related to material transactions, account balances, and disclosures, you still need to evaluate the design of your client's internal control.

.97 ***How to Evaluate Control Design.*** In evaluating control design, it is helpful to consider:

- Whether control objectives that are specific to the unique circumstances of the client have been considered for all relevant assertions for all significant accounts and disclosures
- Whether the control or combination of controls would—if operated as designed—meet the control objective
- Whether all controls necessary to meet the control objective are in place

Determining If the Control Has Been Implemented

.98 It may be possible that the way in which a control is applied by an entity differs from the description of the control in a policy manual or from one individual's understanding of how the control is applied. For example, your client's accounting policy manual may state that physical inventory accounts are performed annually. However, because of increases in the volume of transactions, the client deviates from this stated policy and counts some inventory items twice a year. This practice is not reflected in the policy manual and is not known by all individuals in the company. Determining whether a control has been implemented is important because it confirms your understanding of control design.

.99 The determination of whether a control has been put in place and is in use involves obtaining evidence about whether those individuals responsible for performing the prescribed procedures have:

- An awareness of the existence of the procedure and their responsibility for its performance
- A working knowledge of how the procedure should be performed

.100 Determining whether the control has been implemented does not require you to determine whether the control was performed properly throughout the audit period.

.101 ***Distinguishing Between Evaluation of Design and Tests of Controls.*** Obtaining an understanding of the design and implementation of internal control is different from testing its operating effectiveness.

- *Understanding design and implementation* is required on every audit as part of the process of assessing the risks of material misstatement.
- *Testing the operating effectiveness* builds on your understanding of internal control design and implementation and is necessary only where the auditor's risk assessment procedures include an expectation that the controls will be effective or when substantive procedures alone do not provide you with sufficient audit evidence at the assertion level.

.102 The procedures necessary to understand the design and implementation of controls do provide some limited evidence regarding the operation of the control.[2]

.103 However, the procedures necessary to understand the design and implementation of controls generally are not sufficient to serve as a test of their operating effectiveness for the purpose of placing significant reliance on their operation. For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence about the operating effectiveness of control at other times during the period under audit.

.104 Examples of situations where the procedures you perform to understand the design and implementation of controls may provide sufficient audit evidence about their operating effectiveness include:

- Controls that are automated to the degree that they can be performed consistently provided that IT general controls over those automated controls operated effectively during the period.
- Controls that operate only at a point in time rather than continuously throughout the period. For example, if the client performs an annual physical inventory count, your observation of that count and other procedures to evaluate its design and implementation provide you with evidence that you consider in the design of your substantive procedures.

.105 ***Evaluating Design and Implementation in the Absence of Control Documentation.*** For smaller companies, the company's evidence supporting the design and implementation of some elements of internal control may not be available in documentary form. For example, the entity may lack:

- A written code of conduct that describes management's commitment to ethical values
- A formal risk assessment process

.106 Without adequate documentation of controls, the risk assessment procedures available to you to understand control design are limited to inquiry and observation. As risk assessment procedures, both inquiry and observation have limitations, and accordingly, absent adequate documentation, you should consider whether the information you have gathered about internal control is sufficient to evaluate its design.

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[2] For example, a walkthrough that traces a transaction from its inception through its recording is considered a test of one transaction. Examination of several documents evidencing the operation of a control at a key control point may also be considered as a test. Generally, the evidence required to rely on the operation of the control will be greater than that required to simply assess whether it has been placed in operation.

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.107 Inadequate documentation of the components of internal control also may be a control deficiency. For example, the lack of appropriate documentation may impair management's ability to communicate control procedures to those responsible for their performance or to monitor control performance effectively.

Discussion Among the Audit Team

.108 The members of the audit team should discuss the susceptibility of the client's financial statements to material misstatement. This discussion will allow team members to exchange information and create a shared understanding of the client and its environment, which in turn will enable each team member to:

- Gain a better understanding of the potential for material misstatement resulting from fraud or error in the assertions that are relevant to the areas assigned to them
- Understand how the results of the audit procedures that they perform may affect other aspects of the audit.

This discussion among the audit team could be held at the same time as the discussion among the team related to fraud, which is required by AU section 316.

Assessing the Risk of Material Misstatement

Considerations at the Financial Statement Level

.109 You should use your understanding of the client and its environment—which includes your evaluation of the design and implementation of internal control—to assess the risk of material misstatement. To make this assessment, you should:

1. Identify risks throughout the process of obtaining an understanding of the entity, its internal control, and its environment.
2. Relate the identified risks to what can go wrong at the relevant assertion level.
3. Consider whether the risks could result in a material misstatement to the financial statements.
4. Consider the likelihood that the risks could result in a material misstatement of the financial statements.

.110 ***Financial Statement-Level and Assertion-Level Risks.*** You should identify and assess the risks of material misstatement at both the financial statement level and the relevant assertion level.

1. *Financial statement-level risks.* Some risks of material misstatement relate pervasively to the financial statements taken as a whole and potentially affect many relevant assertions. These risks at the financial statement level may be identifiable with specific assertions at the class of transaction, account balance, or disclosure level.
2. *Relevant assertion-level risks.* Other risks of material misstatement relate to specific classes of transactions, account balances, and disclosures at the assertion level. Your assessment of risks at the assertion level provides a basis for considering the appropriate audit approach for designing and performing further audit procedures.

.111 Risks that exist at the financial statement level, for example, those that pertain to a weak control environment or to management's process for making significant accounting estimates, should be related to specific assertions. For example, risks related to the client's process for making accounting estimates would affect those assertions where an accounting estimate was necessary (for example, the valuation of assets).

.112 In other instances, it may not be possible for you to relate your financial statement-level risks to a particular assertion or group of assertions. For example, it may not be possible for you to determine which assertions will or will not be affected by a weak control environment. Financial statement-level assertions that can not be related to specific assertions will require you to make an overall response, such as the way in which the audit is staffed or supervised.

.113 ***How to Consider Internal Control When Assessing Risks.*** Your evaluation of internal control design and the determination of whether controls have been implemented are integral components of the risk assessment process. When making risk assessments, you should identify the controls that are likely to either prevent or detect and correct material misstatements in specific assertions. For example, procedures relating to the client's physical inventory count may relate specifically to the existence or completeness of inventory.

.114 Individual controls often do not address a risk completely in themselves. Often, only multiple control activities, together with other components of internal control (for example, the control environment, risk assessment, information and communication, or monitoring), will be sufficient to address a risk. For this reason, when determining whether identified controls are likely to prevent or detect and correct material misstatements, you generally organize your risk assessment procedures according to significant transactions and accounting processes (for example, sales, cash receipts, or payroll), rather than general ledger accounts.

.115 ***Identification of Significant Risks.*** As part of your risk assessment, you should identify significant risks, which are defined as those risks that require special audit consideration. For example, if your client is named as a defendant in a patent infringement lawsuit that may threaten the viability of its principal product, you could consider as significant risks, the risks that the lawsuit (1) would not be appropriately recorded or disclosed in accordance with generally accepted accounting principles or (2) may affect the entity's ability to continue as a going concern.

.116 Significant risks arise on most audits. When you determine that a risk is a significant risk, your audit procedures should include (but not be limited to):

- Obtaining an understanding of internal control, including relevant control activities, related specifically to those significant risks.
- If you plan to rely on the operating effectiveness of controls related to significant risks, testing the operating effectiveness of those controls in the current period. That is, using evidence about operating effectiveness that you obtained in prior periods is not appropriate.
- Substantive procedures specifically designed to address the significant risk.

.117 Significant risks should be distinguished from transactions or events that have a high inherent risk, which could be mitigated by the client's internal controls. For example, because of the nature of your client and the industry in which it operates, you might assess a high inherent risk on revenue recognition. However, the client may have controls over revenue recognition; you would then obtain an understanding of such controls and determine whether they are implemented and, if appropriate, test their operating effectiveness. This circumstance may not warrant special audit consideration and thus may not be a significant risk.

.118 The determination of whether a transaction or event is a significant risk is a matter for your professional judgment.

Considerations at the Assertion Level

.119 Part Two of this Alert provides a definition of audit risk (AR) in which:

AR = RMM x DR

where RMM is the risk of material misstatement and DR is detection risk

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The risk of material misstatement is described as "the entity's risk," which means that it is independent of your audit. You can control detection risk by changing the nature, timing, and extent of your audit procedures. For example, to decrease the planned level of detection risk, you could perform more extensive substantive tests.

.120 You cannot control the risk of material misstatement as you can detection risk because RMM exists independently from your audit procedures. However, to properly gauge the detection risk you are willing to accept, you need to assess the risks of material misstatement. The risk assessment process described in the SASs is designed to allow you to gather information and assess the risks of material misstatement so you can design further audit procedures that reduce audit risk to an acceptably low level.

Determining Materiality and Tolerable Misstatement

.121 You should determine a materiality level for the financial statements taken as a whole when establishing the overall audit strategy for the audit. The determination of materiality will assist you in (1) making judgments when identifying and assessing the risk of material misstatement and (2) determining the nature, timing, and extent of your further audit procedures. In determining financial statement materiality, you will often apply percentages to benchmarks. The determination of materiality, including the selection of the appropriate benchmark and percentages, is a matter of your professional judgment and depends on the nature and circumstances of your audit.

.122 In addition to the quantitative considerations, you should be alert for misstatements that could be qualitatively material, for example, misstatements that may change a loss into income or vice versa, may potentially affect loan covenants, or may increase management's compensation.

.123 After you determine the financial statement materiality, you should set a tolerable misstatement, which is the adjustment of the financial statement materiality to the assertion level. Tolerable misstatement will assist you in assessing the risk of material misstatement and in designing and performing further audit procedures.

.124 Because the entity's circumstances may change as the audit progresses, you should reassess the financial statement materiality and tolerable misstatement levels initially determined. Failure to do so may result in you failing to obtain sufficient audit evidence to support your opinion.

Responding to Assessed Risks

Linking Assessed Risks to Further Audit Procedures

.125 The risk assessment process culminates with your articulation of the account balances, classes of transactions, or disclosures where material misstatements are most likely to occur. This assessment of risk relates identified risks to what can go wrong at the assertion level and the way in which misstatements are likely to occur. Your risk assessment provides the basis for designing and performing further audit procedures.

.126 You can think of your assessment of risks as having two dimensions: direction and amplitude. Direction relates to where misstatements can occur, that is, the specific assertions related to an account, class of transactions, or disclosure. Amplitude relates to the possible magnitude of the misstatement that could occur. Magnitude is a function of two variables: the potential significance of the misstatement (for example, whether it is material) and the likelihood of a misstatement occurring (for example, remote, likely). Your evaluation of the design and implementation of internal control affects all elements of your risk assessment process.

Further Audit Procedures

.127 You perform further audit procedures to obtain the audit evidence necessary to support your audit opinion. Further audit procedures consist of either tests of controls or substantive tests. Often, a combined approach using both tests of controls and substantive procedures is an effective approach. You are not precluded from adapting a substantive audit approach provided that you have and document an appropriate basis for this approach.

.128 In determining the nature, timing, and extent of further audit procedures, you should design and perform further procedures whose nature, timing, and extent are responsive to the assessed risk of material misstatement at the relevant assertion level. You should provide and document a clear linkage between your assessment of the risk of material misstatement and the nature, timing, and extent of the further audit procedures.

.129 Audit procedures performed in previous audits and example procedures provided by illustrative audit programs may help you understand the types of further audit procedures that are possible for you to perform. However, prior year procedures and example audit programs do not provide a sufficient basis for determining the nature, timing, and extent of audit procedures to perform in the current audit. Your assessment of the risk of material misstatement in the current period is the primary basis for designing further audit procedures in the current period.

Evaluating Audit Findings

.130 In evaluating whether the financial statements are presented fairly, you must consider the effects, both individually and in the aggregate, of misstatements (known and likely) identified by you that are not corrected by the client.

.131 Your consideration and aggregation of misstatements should include both of the following:

- Known misstatements, which are the amount of misstatements specifically identified
- Likely misstatements, which include (1) projected misstatements in the account balances or classes of transactions that you have examined and (2) differences between management's and the auditor's judgments concerning accounting estimates that the auditor considers unreasonable or inappropriate.

.132 Misstatements should be aggregated in a way that enables the auditor to consider whether, in relation to individual amounts, subtotals, or totals in the financial statements, they materially misstate the financial statements taken as a whole.

.133 Before considering the aggregate effect of identified uncorrected misstatements, the auditor should consider each misstatement separately to evaluate:

1. Its effect in relation to the relevant individual classes of transactions, account balances, or disclosures, including qualitative considerations.
2. Whether, in considering the effect of the individual misstatement on the financial statements taken as a whole, it is appropriate to offset misstatements. For example, it may be appropriate to offset misstatements of items within the same account balance in the financial statements.
3. The effect of misstatements related to prior periods. In prior periods, misstatements may not have been corrected by the entity because they did not cause the financial statements for those periods to be materially misstated. Those misstatements might also affect the current period's financial statements.

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.134 In aggregating misstatements, you should include the effect on the current period's financial statements of those prior period misstatements. When evaluating the aggregate uncorrected misstatements, you should consider the effects of these uncorrected misstatements in determining whether the financial statements are free of material misstatement.

.135 There are quantitative and qualitative materiality considerations, and you should consider both when evaluating audit results. Because of qualitative considerations, misstatements of relatively small amounts could have a material effect on the financial statements. For example, an illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue.

Evaluating Whether the Financial Statements Taken as a Whole Are Free of Material Misstatement

.136 You must evaluate whether the financial statements taken as a whole are free of material misstatement. In making this evaluation, you should consider the evaluation of the uncorrected (known and likely) misstatements you identified during the audit. When concluding about whether the effect of misstatements, individually or in the aggregate, is material, you should consider the nature and amount of the misstatements in relation to the nature and amount of items in the financial statements under audit. For example, an amount that is material to the financial statements of one entity may not be material to the financial statements of another entity of a different size or nature. Also, what is material to the financial statements of a particular entity might change from one period to another.

.137 If you believe that the financial statements taken as a whole are materially misstated, you should request management to make the necessary corrections. If management refuses to make the corrections, you must determine the implications for the auditor's report.

.138 If you conclude that the effects of uncorrected misstatements are not material, you should consider that the financial statements themselves could still be materially misstated because of additional misstatements that you did not detect. As the aggregate misstatements approach materiality, the risk that the financial statements may be materially misstated also increases. Accordingly, you should consider the effect of undetected misstatements in concluding whether the financial statements are fairly stated.

The Iterative Nature of Auditing

.139 An audit of financial statements is a cumulative and iterative process. As you perform planned audit procedures—whether they be risk assessment procedures, substantive tests, or tests of controls—the audit evidence you obtain may cause you to modify the nature, timing, or extent of other planned audit procedures. Information may come to your attention that differs significantly from the information on which the risk assessments were based.

.140 For example, the extent of misstatements that you detect by performing substantive procedures may alter your judgment about the risk assessments and may indicate a material weakness in internal control. Or, analytical procedures performed at the overall review stage of the audit may indicate a previously unrecognized risk of material misstatement. In such circumstances, you should reevaluate the planned audit procedures based on the revised consideration of assessed risks.

Audit Documentation

General Documentation Requirements

.141 In general, you should document certain matters pertaining to each step in the risk assessment process. This audit documentation should provide a clear understanding of the work performed, the source of the information, and the conclusions reached.

.142 The form and content of audit documentation are for you to determine using professional judgment. AU section 339, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1), provides general guidance regarding the purpose, content, ownership, and confidentiality of audit documentation. Examples of common documentation techniques include narrative descriptions, questionnaires, checklists, and flowcharts. These techniques may be used alone or in combination.

.143 The form and extent of your documentation are influenced by the following:

- The nature, size, and complexity of the entity and its environment
- The availability of information from the entity
- The specific audit methodology and technology used in the course of the audit

.144 For example, documentation of the understanding of a complex information system in which a large volume of transactions are electronically initiated, authorized, recorded, processed, or reported may include flowcharts, questionnaires, or decision tables. For an information system making limited or no use of IT or for which few transactions are processed, documentation in the form of a memorandum may be sufficient. Generally, the more complex the entity and its environment, and the more extensive the audit procedures performed by the auditor, the more extensive your documentation should be. The specific audit methodology and technology used in the course of the audit will also affect the form and extent of documentation.

Specific Documentation Requirements

.145 The SASs require you to document the following matters.

- The levels of materiality and tolerable misstatement, including any changes thereto, used in the audit and the basis on which those levels were determined.
- The discussion among the audit team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, including how and when the discussion occurred, the subject matter discussed, the audit team members who participated, and significant decisions reached concerning planned responses at the financial statement and relevant assertion levels.
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment, including each of the components of internal control, to assess the risks of material misstatement of the financial statements, the sources of information from which the understanding was obtained, and the risk assessment procedures.
- The assessment of the risks of material misstatement both at the financial statement level and at the relevant assertion level and the basis for the assessment.
- The significant risks identified and related controls evaluated.
- The overall responses to address the assessed risks of misstatement at the financial statement level.
- The nature, timing, and extent of the further audit procedures.
- The linkage of those procedures with the assessed risks at the relevant assertion level.
- The results of the audit procedures.
- The conclusions reached with regard to the use in the current audit of audit evidence about the operating effectiveness of controls that was obtained in a prior audit.
- A summary of uncorrected misstatements, other than those that are trivial, related to known and likely misstatements.
- Your conclusion about whether uncorrected misstatements, individually or in aggregate, do or do not cause the financial statements to be materially misstated, and the basis for that conclusion.

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.146 Uncorrected misstatements should be documented in a manner that allows the auditor to:

- Separately consider the effects of known and likely misstatements, including uncorrected misstatements identified in prior periods.
- Consider the aggregate effect of misstatements on the financial statements.
- Consider the qualitative factors that are relevant to the auditor's consideration of whether misstatements are material.

Resource Central

.147 The AICPA will offer continuing professional education courses, including a self-study course as well as a group study course. In addition, the new risk assessment standards will be a topic of discussion in various AICPA conferences in which AICPA presenters will further explain the standards.

On the Bookshelf

Future AICPA Audit Guide on Risk Assessment and Internal Control

.148 The AICPA is currently developing an Audit Guide to aid in implementing the new risk assessment standards. In addition, the AICPA is revamping its existing Audit Guide titled *Consideration of Internal Control in a Financial Statement Audit*. The current development plan envisions combining these two guides into one audit guide. This audit guide should be available by mid-2006 and can be purchased by contacting the AICPA/CPA2Biz Service Center at (888) 777-7077 or online at www.cpa2biz.com.

AICPA's reSOURCE Online Accounting and Auditing Literature

.149 Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, *Audit and Accounting Guides*, Audit Risk Alerts, and *Accounting Trends & Techniques.* To subscribe to this essential service, go to www.cpa2biz.com.

reSOURCE CD-ROM

.150 The AICPA is currently offering a CD-ROM product entitled *reSOURCE: AICPA's Accounting and Auditing Literature.* This CD-ROM enables subscription access to AICPA Professional Literature products in a Windows format, namely, *Professional Standards*,*Technical Practice Aids*, and *Audit and Accounting Guides* (available for purchase as a set or as individual publications). This dynamic product allows you to purchase the specific titles you need and includes hypertext links to references within and between all products.

AICPA/CPA2Biz Service Center

.151 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA/CPA2Biz Service Center at (888) 777-7077. The best times to call are 8:30 A.M. to 11:30 A.M. and 2:00 P.M. to 7:30 P.M., Eastern Standard Time. You can also order AICPA products from the Service Center by fax at (800) 362-5066 or visit www.cpa2biz.com to obtain product information and place online orders.

Hotlines

Accounting and Auditing Technical Hotline

.152 The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

.153 Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Websites

AICPA Online and CPA2Biz

.154 AICPA Online (www.aicpa.org) offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the *Audit and Accounting Guides*, *Professional Standards*, CPE courses, Practice Aids, and Audit Risk Alerts.

.155 Any comments that you have about this Alert may be e-mailed to lpombo@aicpa.org or mailed to:

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AAM Section 8300

Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115

COMPANION TO SAS N0. 115, COMMUNICATING INTERNAL CONTROL RELATED MATTERS IDENTIFIED IN AN AUDIT

Notice to Readers

This Audit Risk Alert is intended to help auditors understand and implement the requirements of Statement on Auditing Standards (SAS) No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), which supersedes SAS No. 112 of the same name.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards*. Other Auditing Publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an other auditing publication, he or she should be satisfied that, in his or her judgment, it is both appropriate and relevant to the circumstances of his or her audit. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

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Technical Manager
Accounting and Auditing Publications

Introduction

.01 In October 2008, the AICPA Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 115, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 115 amends SAS No. 112 and further clarifies standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements.

.02 The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) except when the auditor is performing an integrated audit and will be expressing an opinion on the effectiveness of internal control over financial reporting under AT section 501 (AICPA, *Professional Standards*, vol. 1). This new standard is effective for audits of financial statements for periods ending on or after December 15, 2009. This Audit Risk Alert provides an overview of the requirements of SAS No. 115 as well as case studies that illustrate how deficiencies in internal control may be evaluated for severity.

Why SAS No. 115 Was Issued

.03 The Sarbanes-Oxley Act of 2002 and the issuance of Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*, which has since been superseded by PCAOB Auditing

Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Standards"), created considerable interest in management's responsibility for internal control and the auditor's responsibility for bringing certain internal control related matters to management's attention in an audit of financial statements. This renewed interest in an auditor's responsibility to report internal control deficiencies identified in an audit in conjunction with the goal of the ASB to converge definitions with Auditing Standard No. 2 led the ASB to issue SAS No. 112. By issuing SAS No. 115, the ASB revised SAS No. 112 maintain the uniformity of the definitions of the various kinds of deficiencies in internal control and the related guidance for evaluating such deficiencies with the definitions and guidance in Auditing Standard No. 5.

Overview of the Standard

.04 In general, SAS No. 115 retains many of the provisions of SAS No. 112; it provides guidance to enhance the auditor's ability to identify and evaluate deficiencies in internal control during an audit, and then communicate to management and those charged with governance those deficiencies that the auditor believes are significant deficiencies or material weaknesses.

.05 The key differences between SAS No. 115 and SAS No. 112 lie in the definitions of material weaknesses and significant deficiencies and the process for making that determination. Under SAS No. 112, the auditor applied criteria of likelihood and magnitude described in that standard to determine if a control deficiency reached the threshold of significant deficiency or material weakness. Under SAS No. 115, the same criteria are used; however, more judgment is allowed for in determining whether a control deficiency is a significant deficiency.

Identifying Deficiencies in Internal Control

.06 A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis:

- A deficiency in design exists when *(a)* a control necessary to meet the control objective is missing or *(b)* an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met.
- A deficiency in operation exists when *(a)* a properly designed control does not operate as designed or *(b)* when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

The Auditor's Responsibility for Identifying Deficiencies in Internal Control

.07 When conducting an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control. However, during the course of the audit, the auditor may become aware of deficiencies in the design or operation of the entity's internal control. The auditor may identify deficiencies in internal control at any point in the audit, for example, while

- obtaining an understanding of the entity and its environment, including its internal control,
- assessing the risks of material misstatement of the financial statements, due to error or fraud,
- performing further audit procedures to respond to assessed risks, or
- communicating with management or others (for example, internal auditors or governmental authorities).

.08 The awareness of deficiencies in internal control will vary with each audit and will be influenced by the nature, timing, and extent of audit procedures performed, as well as other factors. The results of substantive procedures may result in the need to reevaluate the earlier assessment of internal control.

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Evaluating Deficiencies in Internal Control

.09 A deficiency in internal control may be considered just a deficiency. More severe deficiencies are *significant deficiencies*, and the most severe deficiencies are *material weaknesses*.

Definitions of Significant Deficiency and Material Weakness

.10 A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. For the purpose of this definition, a reasonable possibility exists when the likelihood of the event is either *reasonably possible* or *probable* as those terms are used in Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*.[1, 2]

.11 A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

The Evaluation Process

.12 The auditor should evaluate the severity of each deficiency in internal control identified during the audit and determine whether the deficiency, individually or in combination with other deficiencies in internal control, rise to the level of significant deficiencies or material weaknesses. The severity of a deficiency in internal control depends on

- the magnitude of the potential misstatement resulting from the deficiency or deficiencies; and
- whether there is a reasonable possibility that the entity's controls will fail to prevent or to detect and correct a misstatement of an account balance or disclosure.

.13 The severity of a deficiency does not depend on whether a misstatement actually occurred. If the auditor identifies a deficiency in internal control but has not identified an actual misstatement related to that deficiency, the auditor cannot automatically conclude that the deficiency is not a significant deficiency or a material weakness. If a misstatement has been identified, the auditor should consider the potential for further misstatement in the financial statements being audited.

Magnitude

.14 Magnitude refers to the extent of the misstatement that could have occurred, or that actually occurred, because misstatements include both potential and actual misstatements. In evaluating the magnitude of the potential misstatement, the maximum amount by which an account balance or total of transactions can be overstated generally is the recorded amount, whereas understatements could be larger. For example, if a control deficiency exists over the completeness of accounts payable, and the recorded amount is $200,000, the most the amount could be overstated is $200,000. But the most the amount could be understated cannot be known.

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[1] The term *reasonable possibility* as used in the definitions of the term *material weakness* has the same meaning as defined in Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*. Paragraph 3 of FASB Statement No. 5 states:

> When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. This statement uses the terms probable, reasonably possible, and remote to identify three areas within that range, as follows:
>
> *a.* *Probable.* The future event or events are likely to occur.
>
> *b.* *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
>
> *c.* *Remote.* The chance of the future event or events occurring is slight.

Therefore, the likelihood of an event is a *reasonable possibility* when it is reasonably possible or probable.

[2] At the time of this writing, the FASB *Accounting Standards Codification* (ASC) had not yet been issued as authoritative. When the FASB ASC is issued as authoritative, the definitions currently found in FASB Statement No. 5 will be located at FASB ASC 450-20-25-1.

.15 Factors that affect the magnitude of a misstatement that might result from a deficiency or deficiencies include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency
- The volume of activity (in the current period or expected in future periods) in the account or class of transactions exposed to the deficiency

Probability of Occurrence

.16 Probability of occurrence refers to the likelihood that a control, or combination of controls, could have failed to prevent or detect a misstatement in the financial statements being audited. The evaluation of whether a deficiency presents a reasonable possibility of misstatement may be made without quantifying the probability of occurrence as a specific percentage or range. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

.17 Risk factors affect whether a reasonable possibility exists that a deficiency, or a combination of deficiencies, will result in a misstatement of an account balance or disclosure. The factors include, but are not limited to, the following:

- The nature of the financial statement accounts, classes of transactions, disclosures, and assertions involved
- The susceptibility of the related asset or liability to loss or fraud
- The subjectivity, complexity, or extent of judgment required to determine the amount involved
- The interaction or relationship of the control with other controls
- The interaction among the deficiencies
- The possible future consequences of the deficiency

.18 The following table summarizes the consideration of the severity of a deficiency to determine whether it is a deficiency in internal control, a significant deficiency, or a material weakness.

Magnitude of misstatement that occurred, or could have occurred	***Probability of misstatement***	
	Reasonably Possible	*Remote*
Quantitatively or qualitatively material	Material weakness	Deficiency in internal control that could be a significant deficiency but not a material weakness
Less than material	Deficiency in internal control that could be a significant deficiency but not a material weakness	Deficiency in internal control that could be a significant deficiency but not a material weakness

.19 As shown in the preceding table, a deficiency in internal control that is less than material, less than reasonably possible, or both, could be considered a significant deficiency if it is determined by the auditor's professional judgment to merit the attention of those charged with governance.

.20 The following are examples of deficiencies in internal control and how their magnitude and probability of occurrence might be considered:

- *A deficiency in controls over revenue transactions that results in a financial statement misstatement.* In this case, the auditor assesses the probability of a control preventing or detecting and correcting the misstatement.

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Because the misstatement actually occurred, the auditor assesses the probability as reasonably possible. The auditor then considers the potential magnitude of the misstatement. If the amounts are greater than materiality, the control deficiency would be classified as a material weakness. If the amounts are less than material, the auditor would apply his or her professional judgment as to whether this deficiency is important enough to merit the attention of those charged with governance.

- *Failure to obtain required authorization for a valid disbursement.* In this situation, the auditor again assesses the probability of the control failing and the magnitude of the misstatement that could result from recording an unauthorized disbursement, using the factors listed previously.

Multiple Deficiencies in Internal Control

.21 Multiple deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control increase the likelihood of material misstatement and may, in combination, constitute a significant deficiency or a material weakness, even though such deficiencies individually may be less severe. Therefore, the auditor should determine whether deficiencies that affect the same significant account or disclosure, relevant assertion, or component of internal control collectively result in a significant deficiency or a material weakness.

Mitigating Effects of Compensating Controls

.22 When a deficiency in internal control has been identified, management may inform the auditor, or the auditor may otherwise become aware of the existence of compensating controls that, if effective, may limit the severity of the deficiency in internal control and prevent it from being a significant deficiency or material weakness. In these circumstances, although the auditor is not required to consider the effects of compensating controls for purposes of this standard, the auditor may rely on the operating effectiveness of compensating controls related to a deficiency in operation provided the auditor has tested the compensating controls for operating effectiveness as part of the financial statement audit. Compensating controls can limit the severity of the deficiency, but they do not eliminate the deficiency.

.23 For example, consider a situation in which there is a lack of segregation of duties within the accounts payable function in an owner-managed entity. As a compensating control, the owner reviews the supporting documentation for all disbursements exceeding $1,000. As part of the audit, the auditor could test this compensating control and determine whether it operates effectively for the purpose of mitigating the effects of the deficiency in internal control (lack of segregation of duties) in the accounts payable function. Although the deficiency in internal control still exists—the review does not eliminate the lack of segregation of duties—the significance of the deficiency may be mitigated by the compensating control so that it is not a significant deficiency or a material weakness.

The Prudent Official Test

.24 If the auditor determines that a deficiency, or a combination of deficiencies, is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion. Although the term *prudent official* is not defined in the standard, the concept is that an auditor should "stand back" and take another objective look at the severity of the deficiency as would a regulator or someone from an oversight agency. The auditor should consider whether a *prudent official* (having the auditor's knowledge about the facts and circumstances, the magnitude and probability of occurrence of the potential misstatement, and the other controls that were tested) would agree with the auditor's conclusion that a deficiency is not a material weakness. Because a prudent official is cautious, the prudent official test is used only to increase the severity of a deficiency in internal control and not to justify a decrease in the severity.

Communication Requirements

Form of Communication

.25 The auditor should communicate *in writing* to management and those charged with governance.

Content of Communication

.26 Deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this section should be communicated, in writing, to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and the date of that communication.

.27 The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should include

- a statement that indicates the purpose of the auditor's consideration of internal control was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity's internal control.
- a statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control.
- a statement that indicates that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
- the definition of the term *material weakness* and, where relevant, the definition of the term *significant deficiency*.
- identification of the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
- a statement that indicates the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.

.28 The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit. Such a communication could be misinterpreted as providing a higher level of assurance than it actually represents.

.29 Paragraph .28 of SAS No. 115 contains an illustrative communication that encompasses the requirements of the standard. In addition, SAS No. 115 contains an illustrative communication that may be used when the auditor has been requested to advise management and those charged with governance of the fact that no material weaknesses were identified. Also illustrated is a paragraph to be added to the auditor's communication when, for the benefit of a regulator, management's response to the auditor's communication of significant deficiencies and material weaknesses is included in a document with the auditor's written communication.

Communicating Other Matters

.30 Nothing in SAS No. 115 precludes the auditor from communicating to management and those charged with governance other matters related to an entity's internal control. For example, the auditor may

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communicate matters the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving controls. The auditor may also communicate deficiencies that are not significant deficiencies or material weaknesses. When other matters are communicated orally, the auditor should document the communication.

Timing of Communication

.31 Best practice is to issue the written communication by the report release date. The auditor should issue the written communication no later than 60 days following the report release date.

.32 For some matters, early communication to management or those charged with governance may be important because of their relative significance and the urgency for corrective follow-up action. Accordingly, the auditor may decide to communicate certain matters during the audit. These matters need not be communicated in writing during the audit, but significant deficiencies and material weaknesses should ultimately be included in a written communication even if such significant deficiencies or material weaknesses were remediated during the audit.

How the Revisions Will Affect Practice

.33 As the auditor gains a better understanding of the entity's system of internal control over financial reporting, he or she may identify more deficiencies in internal control that are

- identified as significant deficiencies and material weaknesses, and
- communicated to management and those charged with governance.

Discussions With Management and Others

.34 The requirements of SAS No. 112 and now SAS No. 115 may change perceptions of the auditor's role in the client's internal control. The auditor may have to explain to clients that the auditor *cannot* be a part of their internal control. How an auditor responds to a client's internal control weakness, in terms of designing and carrying out further auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a control weakness does not change the control weakness. Only the client—not the auditor—can correct deficiencies in internal control. However, a CPA firm other than the auditor can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.35 The auditor may need to hold discussions with management and other users who ask how it is possible to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. The auditor may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control. The auditor can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present, by performing sufficient procedures and obtaining appropriate audit evidence to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct* deficiencies in internal control; the deficiencies in internal control could still result in a material misstatement not being prevented or detected by the client.

Issues for Audits of Smaller Entities

.36 One issue that may arise in audits of smaller entities is the possibility of increased costs as a result of the auditor's time spent documenting his or her evaluation of internal control and evaluating identified deficiencies in internal control.

.37 Another issue that may cause concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of material weakness in internal control if the audit client has ineffective controls over the preparation of their financial statements such that client controls are absent or controls are not effective in preventing or detecting material misstatements in the preparation of financial statements, including the related footnotes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.[3]

Opportunities to Expand Client Services

.38 The requirements of SAS No. 112 and now SAS No. 115 introduce possible opportunities to educate the client in ways that will improve their internal control. Auditors can help clients evaluate the cost/benefit implications of improving their internal control; including training their personnel to be more knowledgeable about accounting, financial statement presentation, and internal control design. Additionally, auditors can teach clients how to develop a risk assessment approach to designing internal control.

Examples

Deficiencies in Internal Control, Significant Deficiencies, or Material Weaknesses

.39 Exhibit B in SAS No. 115 provides examples of circumstances that may be deficiencies in internal control, significant deficiencies, or material weaknesses. This appendix includes one example in addition to those contained in the appendix to SAS No. 112. The following are the items included in the appendix within AU section 325 paragraph .29.

- Deficiencies in the design of controls
    - Inadequate design of controls over the preparation of the financial statements being audited.
    - Inadequate design of controls over a significant account or process.
    - Inadequate documentation of the components of internal control.
    - Insufficient control consciousness within the organization; for example, the tone at the top and the control environment.
    - Absent or inadequate segregation of duties within a significant account or process.
    - Absent or inadequate controls over the safeguarding of assets (this applies to controls that the auditor determines would be necessary for effective internal control over financial reporting).
    - Inadequate design of IT general and application controls that prevent the information system from providing complete and accurate information consistent with financial reporting objectives and current needs.
    - Employees or management who lack the qualifications and training to fulfill their assigned functions. For example, in an entity that prepares financial statements in accordance with generally accepted accounting principles (GAAP), the person responsible for the accounting and reporting function lacks the skills and knowledge to apply GAAP in recording the entity's financial transactions or preparing its financial statements.
    - Inadequate design of monitoring controls used to assess the design and operating effectiveness of the entity's internal control over time.

[3] See Ethics Interpretation 101-3, *Performance of Nonattest Services*, under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101 par. .05).

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    - The absence of an internal process to report deficiencies in internal control to management on a timely basis.

- Failures in the operation of internal control
    - Failure in the operation of effectively designed controls over a significant account or process; for example, the failure of a control such as dual authorization for significant disbursements within the purchasing process.
    - Failure of the information and communication component of internal control to provide complete and accurate output because of deficiencies in timeliness, completeness, or accuracy; for example, the failure to obtain timely and accurate consolidating information from remote locations that is needed to prepare the financial statements.
    - Failure of controls designed to safeguard assets from loss, damage, or misappropriation.
    - Failure to perform reconciliations of significant accounts. For example, accounts receivable subsidiary ledgers are not reconciled to the general ledger account in a timely or accurate manner.
    - Undue bias or lack of objectivity by those responsible for accounting decisions; for example, consistent understatement of expenses or overstatement of allowances at the direction of management.
    - Misrepresentation by entity personnel to the auditor (an indicator of fraud).
    - Management override of controls.
    - Failure of an application control caused by a deficiency in the design or operation of an IT general control.
    - An observed deviation rate that exceeds the number of deviations expected by the auditor in a test of the operating effectiveness of a control. For example, if the auditor designs a test in which he or she selects a sample and expects no deviations, the finding of one deviation is a nonnegligible deviation rate because, based on the results of the auditor's test of the sample, the desired level of confidence was not obtained.

.40 Note that the third circumstance in the preceding list, failure of controls designed to safeguard assets from loss, damage, or misappropriation, may need careful consideration before it is evaluated as a significant deficiency or material weakness. For example, assume that a company uses security devices to safeguard its inventory (preventive controls) and also performs periodic physical inventory counts (detective control) timely in relation to its financial reporting. Although the physical inventory count does not safeguard the inventory from theft or loss, it prevents a material misstatement of the financial statements if performed effectively and timely.

.41 Therefore, given that the definitions of material weakness and significant deficiency relate to the likelihood of misstatement of the financial statements, the failure of a preventive control such as inventory tags will not result in a significant deficiency or material weakness if the detective control (physical inventory) prevents a misstatement of the financial statements. Material weaknesses relating to controls over the safeguarding of assets would only exist if the company does not have effective controls (considering both safeguarding and other controls) to prevent or detect a material misstatement of the financial statements.

Significant Deficiencies

.42 Some examples of deficiencies that might indicate the existence of significant deficiencies in internal control:

- Controls over the selection and application of accounting principles that are in conformity with GAAP; having sufficient expertise in selecting and applying accounting principles is an aspect of such controls
- Antifraud programs and controls

- Controls over nonroutine and nonsystematic transactions
- Controls over the period-end financial reporting process, including controls over procedures used to enter transaction totals into the general ledger; initiate, authorize, record, and process journal entries into the general ledger; and record recurring and nonrecurring adjustments to the financial statements

Material Weaknesses

.43 Some examples of circumstances that indicate a deficiency in internal control that could be regarded as material weaknesses in internal control are

- identification of fraud, whether or not material, on the part of senior management;
- restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud;
- identification by the auditor of a material misstatement of the financial statements under audit in circumstances that indicate that the misstatement would not have been detected by the entity's internal control; and
- ineffective oversight of the entity's financial reporting and internal control by those charged with governance.

Evaluation Questions

.44 When evaluating the severity of a deficiency in internal control, the first step is to determine whether the deficiency is a material weakness. Some questions to consider when making this determination include the following:

- Is the probability that a misstatement of any magnitude could occur and not be detected and corrected on a timely basis by the client's controls reasonably possible?
- Is the magnitude of a potential misstatement material to the financial statements? A misstatement is material, either individually or when aggregated with other misstatements, would cause the entity's financial statements to be materially misstated.

.45 If the answer to both questions is *yes*, then the deficiency is a material weakness. After that determination is made, the auditor may consider additional factors that could mitigate the affect of deficiency in internal control to the point where it can be classified as a deficiency in internal control or significant deficiency in internal control. Consider the answers to the following questions:

- Are there complementary or redundant controls that were tested and evaluated that achieve the same control objective?
- Are there compensating controls that were tested and evaluated that limit the magnitude of a misstatement of the financial statements to less than material?

.46 If the answer to either question is yes, the auditor may evaluate whether the deficiency in internal control is sufficiently mitigated to classify it as less severe than a material weakness in internal control. Before concluding that the control deficiency is not a material weakness, the auditor should consider whether prudent officials, having knowledge of the same facts and circumstances, would likely reach the same conclusion. Deficiencies considered less severe than material weaknesses but important enough to merit the attention of those charged with governance would be classified as significant deficiencies.

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Case Studies

.47 This section contains case studies that highlight a particular deficiency in internal control. Each case study contains a description of the deficiencies in internal control, and an analysis of the assessment of the severity of the deficiency. The deficiencies in internal control discussed are as follows:

- Lack of segregation of duties
- Lack of client expertise in financial accounting and reporting
- Inventory-related deficiencies in internal control
- Failure to review modifications of standard sales contracts to evaluate their effect on the timing and amount of revenue recognition
- Fraud involving cash
- Control testing exceptions

Deficiency in Internal Control 1: Lack of Segregation of Duties

Situation 1

.48 Your client is a small nonprofit organization that has only one person in charge of the accounting and reporting functions. Through your understanding of controls over cash disbursements, you observe a lack of segregation of duties, which is a deficiency in internal control. In assessing the severity of the deficiency in internal control, you consider whether complementary, redundant, or compensating controls exist.

.49 ***Additional Facts.*** Through obtaining your understanding of internal control, you've learned that a board member signs all checks, reviewing invoices that support the disbursement before signing. The signed checks are returned to the client to be mailed. The bank sends the bank statement directly to the board member, who reviews the bank statement and returned checks. The bank statement is then given to the client for reconciliation.

.50 ***Discussion.*** Your assessment of the severity of this deficiency in internal control would be based on the effectiveness of the compensating controls performed by the board members. The compensating controls do not eliminate the deficiency but may mitigate the effects of the deficiency in internal control.

.51 If the board member does not perform a review of the bank statement and the returned checks, verifying that all the checks have the appropriate signature and that the check payee and amount have not been altered, you might determine that the compensating control over disbursements is not effective in achieving the control objective and, therefore, a material weakness exists.

.52 If the board member reviews only returned checks over a certain dollar amount, you might conclude that the compensating control is effective in preventing or detecting a material misstatement of cash and, therefore, this may be considered a significant deficiency because the magnitude of the reasonably possible misstatement is less than material.

.53 However, if the board member examines the returned checks for the appropriate signature and alterations, you might conclude that the compensating control is effective in preventing or detecting an unauthorized disbursement, making the likelihood of a misstatement remote; therefore, this is only a deficiency in internal control and not a significant deficiency or material weakness.

Situation 2

.54 Your client is a small business that has only one person in charge of the accounting and reporting functions. The bookkeeper has been with the company for many years. It is common for the owner to leave

signed, blank checks with the bookkeeper, "in case of emergencies" when the owner is gone. The owner does not perform any oversight procedures. The owner has you, the auditor, perform quarterly interim procedures. The owner believes the auditors are a substitute for his lack of oversight. One of the auditor's quarterly procedures is to review the bank reconciliation, which is prepared by the bookkeeper.

.55 ***Discussion.*** Because the auditor cannot be part of the client's internal control, your interim procedures, including your review of the bank reconciliations, are not compensating controls. Should the bookkeeper betray the owner's trust, the magnitude of a potential misstatement could reasonably be expected to be material. In your professional judgment, you believe that a reasonable person would conclude that there is a reasonable possibility that a misstatement could occur and not be caught by the owner. Thus, the lack of segregation of duties and the lack of oversight would be considered material weaknesses.

Deficiency in Internal Control 2: Lack of Client Expertise in Financial Accounting and Reporting

.56 In situations 3, 4, and 5, you provide assistance to your client in the drafting of the financial statements but, as the auditor, remain independent under Ethics Interpretation 101-3, *Performance of Nonattest Services*, under Rule 101, *Independence* (AICPA, *Professional Standards*, vol. 2, ET sec. 101par. .05). That is, you post client-approved adjusting entries to the trial balance and assist in the drafting of the financial statements from the trial balance. You are not responsible for approving adjusting entries.

Situation 3

.57 Your client's controller is fairly skilled and is able to perform most of the functions necessary to prepare the financial statements. However, the company does not maintain a fixed asset ledger. Rather, you maintain a fixed asset ledger for them on your computer using "off-the-shelf" fixed asset software. From this software package, you are able to print for the controller a projected depreciation schedule, a gain and loss calculation report based on cost, and sales information provided to you by the controller and a final deprecation and fixed asset listing at year-end. The controller provides adequate supervision of the depreciation calculation to ensure that no conflict with Interpretation 101-3 exists. The book and tax depreciation calculation affects depreciation expense for book purposes and also the calculation of deferred taxes. The client could purchase a depreciation program but has concluded it is more cost effective to rely on you for these records.

.58 In most years, the controller provides you with a year-end adjustment if adjustments hadn't already been made to the general ledger. However, in this particular year, the controller has been preoccupied with other tasks and asks you to calculate the year-end depreciation adjustment and gain or loss on sale adjustment. The adjustment is a material adjustment. Because you propose the adjustment, you need to consider whether a deficiency in internal control exists.

.59 ***Discussion.*** In this situation, you would begin by considering whether there is a reasonable possibility that a misstatement would not be detected. Because the auditor cannot be part of a client's internal controls, the controls that exist in your CPA firm to perform the calculations cannot be taken into account in considering whether the client has a deficiency in internal control. Instead, you should consider what controls the client has to detect a misstatement. Based on only these facts, your judgment is that the client has the competency to perform the accounting function but has chosen not to perform these depreciation closing procedures this year.

.60 However, as long as the client reviews the depreciation and related calculations, and you believe such review procedures would prevent, detect, and correct potential misstatements, you may determine that there is not a deficiency in internal control. If the client' procedures or controls are not able to prevent, detect, and correct a misstatement, then you would determine that there is a deficiency in internal control.

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Situation 4

.61 This client has an accounting manager who requests that you assist in drafting the financial statements and notes to the financial statements. However, prior to signing the representation letter, the accounting manager obtains the financial statement grouping schedules and the schedules documenting the calculation of amounts included in the notes to the financial statements, and reviews and approves these schedules. In addition, the accounting manager obtains a current disclosure checklist from the AICPA and reviews and answers the checklist to ensure propriety and completeness of the footnotes. The financial statements are also read, revised, and approved by both the accounting manager and the owner.

.62 ***Discussion.*** Based only on the facts presented, no deficiencies in internal control were observed. You would need to further understand whether the client's controls are designed appropriately and operating effectively, and that would be dependent on the competence and expertise of the client's accounting manager.

.63 In assessing this situation, you would first consider whether a reasonable possibility exists that a material misstatement in the presentation and disclosure of the financial statements, including the related footnotes, could occur without being detected by the accounting manager. If you determine that the accounting manager and owner lack the necessary accounting expertise to detect a misstatement, then that would represent a deficiency in internal control that would need to be evaluated.

.64 However, you might conclude that, despite the accounting manager asking you to assist in drafting the financial statements and footnotes, they (the accounting manger and owner) do possess the necessary accounting expertise to perform effective controls to prevent, detect, and correct a potential misstatement in the financial statements or notes; therefore, you would not have a deficiency in internal control.

Situation 5

.65 At this client, you taught the bookkeeper to record cash receipts and disbursements as well as the adjusting journal entries needed to record accounts receivable and payable at year-end. The bookkeeper follows your directions and prepares a draft of the year-end financial statements from a format you provided, including relevant recurring disclosures.

.66 During your audit, you notice that the owner acquired a new delivery truck that cost $50,000—an amount that is material to the company's financial statements—and financed the acquisition through the dealer's finance company. You determine that the financing lease should be capitalized. The bookkeeper has recorded the monthly cash payments for the truck to the dealership but has not recorded the initial fixed asset and related liability (the owner had told her that he was leasing the truck). In discussing the new truck with the bookkeeper, you further discover that the owner was involved in a collision on the last day of the year while driving the truck, and the company's insurance covered only a small portion of the damages. The financial statements do not reflect the capital lease and the related liability, nor does it reflect the expense and liability for the damages in excess of the company's insurance.

.67 ***Discussion.*** Based only on these facts, you determine that a deficiency in internal control exists because the internal control system did not detect, prevent, or correct the misstatements in the client's drafted financial statements. Because you caught this error, your judgment is that it is reasonably possible that the financial statements would be misstated, and the magnitude of the misstatement is material. Because you are the auditor, you cannot be part of the company's internal control. The company did not have anyone on staff with sufficient expertise to properly analyze the lease and record the fixed asset acquisition, and the bookkeeper was not sufficiently knowledgeable to know that she needed help in recording these events. In this case, the quality of the financial statements was not a result of the company's internal control. As such, you determine that the entity has a material weakness.

.68 If the bookkeeper had called you for guidance about how to account for these events, before recording them, your conclusion may have been different. A discussion with the client about a technical issue is not, in and of itself, an indication of a weakness in the company's internal control. The client's ability to exercise controls to detect a potential misstatement and to gain the necessary competence is a factor you would consider in your understanding of the entity's internal control.

Deficiency in Internal Control 3: Inventory-Related Deficiencies in Internal Control

Situation 6

.69 Your client is a large car dealership. There is a lack of good controls over tracking inventory quantities of dealership parts, but a physical inventory is taken at the end of every quarter. A parts manager was selling dealership parts, not recording the sales, and keeping the receipts. Although the amount of the writedown needed to reflect actual inventory was not material to the financial statements, management became aware of the fraud when the parts manager confessed under questioning.

.70 ***Discussion.*** The purpose of your evaluation is to assess the probability and potential magnitude of a financial statement misstatement, not the likelihood and potential magnitude of a loss due to fraud. Because the preventive controls tracking inventory quantities are weak, the client is relying on detective controls—physical inventory—to catch any potential misstatement. From a design perspective, detective controls are seldom as effective as preventive controls, as evidenced by the fact that the client suffered a loss as a result of the weak preventive controls. However, the physical inventory was effective at detecting the loss, so that the financial statements were not materially misstated. Because you would consider the effect of compensating controls in your assessment of the severity of the deficiency in internal control, you would conclude that the preventive control weakness is mitigated by the detection control to the extent that neither a significant deficiency nor a material weakness in internal control over financial reporting exists.

.71 Although the fraud did not result in a *material* misstatement of the financial statements, the fraud is evidence of a deficiency in internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition. AU section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1), requires that whenever the auditor has determined that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. Therefore, you may wish to include this misappropriation (and other risks of fraud that you have identified) in your written communication of significant deficiencies and material weaknesses.

Deficiency in Internal Control 4: Failure to Review Modifications of Standard Sales Contracts to Evaluate Their Effect on the Timing and Amount of Revenue Recognition

Situation 7

.72 Your client uses a standard sales contract for most transactions. Individual sales transactions are not material. Sales personnel are permitted to modify the terms of the sales contract, including shipping terms. Accounting personnel review the terms of the sales contracts for significant or unusual modifications but do not review changes in the standard shipping terms. The changes in the standard shipping terms could cause a delay in the timing of revenue recognition. Management reviews gross margins on a monthly basis and investigates any significant or unusual relationships. In addition, management reviews the reasonableness of inventory levels at the end of each accounting period. There have been a limited number of instances in which revenue was inappropriately recorded, but the related amounts have not been material.

.73 ***Discussion.*** Based on only these facts, you determine that a deficiency in internal control exists in the design of the entity's controls because no controls are in place to monitor a sales person's ability to modify the standard sales contract. In evaluating the severity of this deficiency in internal control, you consider the

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probability and potential magnitude of a financial statement misstatement resulting from this deficiency. The magnitude could reasonably be expected to be less than material, because individual sales transactions are not material and the compensating controls that mitigate the deficiency, which operate monthly and at the end of each financial reporting period, increase the probability that a material misstatement will be detected. Furthermore, the risk of material misstatement is limited to revenue recognition errors related to shipping terms, as opposed to broader sources of error in revenue recognition.

.74 However, the compensating controls are designed to detect only material misstatements. The controls do not effectively address the detection of misstatements that are less than material, as evidenced by situations in which transactions that were not material were improperly recorded. Therefore, there it is reasonably possible a misstatement that is less than material could occur. If you determined that this deficiency was important enough to merit the attention of management or those charged with governance, you would conclude that this deficiency is a significant deficiency.

Situation 8

.75 Your client has a standard sales contract, but sales personnel frequently modify the terms of the contract. Certain modifications can affect the timing and amount of revenue recognized. Individual sales transactions frequently are material to the entity, and the gross margin can vary significantly for each transaction.

.76 Through your understanding of internal control necessary to plan the audit, you determine that the entity has a design deficiency in that the entity does not have procedures in place for accounting personnel to regularly review modifications to the terms of sales contracts. Although management reviews gross margins on a monthly basis, the significant differences in gross margins for individual transactions make it difficult for management to identify potential misstatements. Improper revenue recognition has occurred in the past, and the amounts have been material.

.77 ***Discussion.*** The magnitude of a financial statement misstatement resulting from this deficiency in internal control would reasonably be expected to be material because individual sales transactions are frequently material, and gross margin can vary significantly with each transaction (which would make compensating controls based on a reasonableness review ineffective). Additionally, improper revenue recognition has occurred, and the amounts have been material. Therefore, the likelihood of material misstatements occurring is reasonably possible. Because, taken together, the magnitude and probability of misstatement of the financial statements resulting from this internal deficiency in internal control is material, you determine that this deficiency is a material weakness.

Situation 9

.78 The entity has a standard sales contract; however, sales personnel frequently modify the terms of the contract. Sales personnel frequently grant unauthorized and unrecorded sales discounts to customers without the knowledge of the accounting department. These discounts are taken by customers, deducted from the amount paid, and recorded as outstanding balances in the accounts receivable aging. Although the amounts of these discounts are individually insignificant, they are material in the aggregate and have occurred consistently during the past few years.

.79 ***Discussion.*** The magnitude of a financial statement misstatement resulting from this deficiency would reasonably be expected to be material, because the frequency of occurrence allows insignificant amounts to become material in the aggregate. It is reasonably possible that a material misstatement of the financial statements would result from this deficiency in internal control (even if the client fully reserved for the uncollectible accounts) due to the probability of material misstatement of the gross accounts receivable balance. Therefore, your judgment is that this deficiency represents a material weakness.

Deficiency in Internal Control 5: Fraud Involving Cash

Situation 10

.80 Your client is a small not-for-profit organization that receives most donations by check from corporate donors. Some donations are made in cash. Cash donations are not material to the financial statements. As a result of your understanding of internal control, you notice that internal control over cash receipts is inadequate. In planning your audit, you identify this as a fraud risk and you perform additional auditing procedures relative to cash receipts. Through inquiry, you learn that someone may be stealing cash. You notify management and as a result of performing certain audit tests you discover evidence that indicates that an employee was pocketing the cash and that cash donations were not being recorded.

.81 ***Discussion.*** Your judgment is that it is reasonably possible that a misstatement exists because the fraud has already occurred. The magnitude of the potential financial statement misstatement resulting from this deficiency would reasonably be expected to be less than material, as total cash sales are less than material. At a minimum, you determine that the matter is important enough that it merits the attention of those charged with governance. Thus, this deficiency is at least a significant deficiency. However, because your client is a not-for-profit organization and cash is a sensitive area, and because fraud is involved, you step back and try to look at this situation from a prudent official's perspective. You consider how a regulator may view this, how a donor may view this, and how others in the nonprofit community may view this. In doing that, your judgment is that a prudent official would probably view an absence of controls over cash receipts as a material weakness. Therefore, you conclude that this is a material weakness.

Deficiency in Internal Control 6: Control Testing Exceptions

Situation 11

.82 In performing tests of controls during the audit, you identify an exception. You determined that the exception was one of numerous internal control exceptions that occurred during the two weeks that the controller was on vacation. Controls operated effectively before he left and after he returned to work. No misstatements in the financial statements were identified relating to that period of time.

.83 ***Discussion.*** You first need to determine whether the control testing exception is a deficiency in internal control before considering the severity of that deficiency in internal control. Effective internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting. Because effective internal control over financial reporting cannot and does not provide absolute assurance of achieving financial reporting objectives, any individual control does not necessarily have to operate perfectly, all the time, to be considered effective. You may want to gather additional evidence, beyond what you had initially planned and beyond inquiry, to support your conclusion that the exception does not represent a deficiency in internal control.

.84 You cannot use the lack of actual misstatements to lessen the severity of the deficiency in internal control in your determination, because you have to consider *potential* misstatements of any magnitude. Factors to consider in making your determination would include complementary, redundant, or compensating controls, which could include the monitoring activities undertaken by the controller upon returning from vacation.

Resource Central

.85 The following resources may be beneficial to practitioners and their clients.

Publications

.86 Practitioners may find the following publications useful. Choose the format best for you—online, print, or CD-ROM.

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- Audit Guide *Analytical Procedures* (2008) (product no. 012558kk [paperback], WAN-XXkk [online], or DAN-XXkk [CD-ROM])
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk [paperback] or WRA-XXkk [online])
- Audit Risk Alert *Independence and Ethics Developments—2008* (product no. 022479kk [paperback], WIA-XXkk [online], or DIA-XXkk [CD-ROM])
- *Internal Control—Integrated Framework* (product no. 990012kk [paperback])
- *Financial Reporting Fraud: A Practical Guide to Detection and Internal Control* (product no. 029879kk [paperback])
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk [paperback])

AICPA reSOURCE: Accounting and Auditing Literature

.87 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, you can sign up for access to the entire library. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, *Technical Practice Aids*, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.88 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *Internal Control and IT: Reliable Reporting and Fraud Prevention*, a CPE course that provides an overview of the key auditing standards, conceptual frameworks, IT infrastructures, and auditing issues you are likely to face on medium to small company engagements. (Product no. 732553)
- *Internal Control Essentials for Financial Managers, Accountants and Auditors*, a basic course designed to give participants a solid understanding of systems and control documentation at the significant process level. This course will benefit controllers, managers, and internal auditors in businesses as well as auditors and consultants to public and private companies who need a review. (Product no. 731853kk)

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.89 AICPA CPExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz, is AICPA's flagship online learning product. AICPA members pay $180 for a new subscription and $149 for the annual renewal. Nonmembers pay $435 for a new subscription and $375 for the annual renewal. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics including

- *Internal Controls: Risk Assessment and Fraud - An In-Depth Review*
- *Internal Controls: Controls for Smaller Entities*
- *Internal Controls: The Control Environment - An In-Depth Review*

Webcasts

.90 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts.

Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.91 The CFO Quarterly Roundtable Series, brought to you each calendar quarter via webcast, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.92 The Securities and Exchange Commission (SEC) Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.93 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.94 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. Beginning January 14, 2008, hotline hours were extended so that the hotline is now available from 9 a.m. to 8 p.m. on weekdays. You can reach the Technical Hotline at (877) 242-7212 or at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx.

Ethics Hotline

.95 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077 or by e-mail at ethics@aicpa.org.

AICPA Governmental Audit Quality Center

.96 The Governmental Audit Quality Center (GAQC) is a firm-based, voluntary membership center designed to help CPAs meet the challenges of performing quality audits in this unique and complex area. The GAQC's primary purpose is to promote the importance of quality governmental audits and the value of such audits to purchasers of governmental audit services. The GAQC also offers resources to enhance the quality of a firm's governmental audits.

.97 The mission of the GAQC is to do the following:

- Raise awareness about the importance of governmental audits
- Serve as a comprehensive resource provider on governmental audits for member firms
- Create a community of firms that demonstrates a commitment to governmental audit quality

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- Provide center members with an online forum tool for sharing best practices and discussing audit, accounting, and regulatory issues
- List member firms to enable purchasers of governmental audit services to identify firms that are members
- Provide information about the center's activities to other governmental audit stakeholders

For more information about the GAQC, visit www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Pages/GAQC.aspx.

The Center for Audit Quality

.98 The Center for Audit Quality (CAQ), which is affiliated with the AICPA, was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.99 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit www.aicpa.org/InterestAreas/CenterForAuditQuality/Pages/CAQHome.aspx.

Employee Benefit Plan Audit Quality Center

.100 The AICPA Employee Benefit Plan Audit Quality Center is a firm-based, voluntary membership center created in March 2003 with the goal of promoting quality employee benefit plan audits. The center now has more than 1,500 members in all 50 states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico.

.101 Reviews performed by the U.S. Department of Labor's Employee Benefits Security Administration continue to show a difference in the quality of Employee Retirement Income Security Act audits performed by center member firms compared with those performed by nonmember firms. As members of the center, firms have tools and resources that are not available from any other source. In addition to providing periodic e-alerts with information about recent developments affecting employee benefit plan audits, the center has recently made available to its members

- accounting and auditing resource centers about Section 403(b) plan audits, SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), SAS No. 112, the risk assessment standards, stable value investments, and the Pension Protection Act of 2006.
- "Live Forum" and "Roundtable Discussion" conference calls to share important information and answer participant questions on a wide range of technical and practice topics. As an added benefit, the center now offers a CPE option for most calls.
- two new "Topix" primers on cash balance plans and Section 403(b) plans to help members gain a general understanding of these types of plans.
- three new "Plan Advisories" for members to share with plan stakeholders about issues of importance for plan auditors, including the plan sponsor and trustees' responsibility for monitoring their TPAs, the importance of internal controls, and the plan sponsor's responsibility for valuing plan investments.

.102 Visit the center website at www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Pages/EBPAQhomepage.aspx to see a complete list of center members and to preview center benefits. For more information, contact the center at ebpaqc@aicpa.org.

Antifraud/Forensic Accounting Resource Center

.103 The AICPA's Antifraud/Forensic Accounting Resource Center may be found at www.aicpa.org/InterestAreas/ForensicAndValuation/Resources/ForensicAcctg/Pages/default.aspx. The center contains a variety of tools for auditors, financial managers and those charged with governance. Topics covered in the resource center include identifying internal control risk factors and fraud prevention, detection and investigation in a variety of practical formats including checklists, guides, and case studies.

Audit Committee Effectiveness Center

.104 Realizing that financial statement integrity and reliability depends upon balancing the pressures of multiple stakeholders, including management, regulators, investors, and the public interest, this center provides guidance and tools to make audit committee best practices actionable. Several audit committee toolkits are offered through this center, including those for public companies, not-for-profits, and governments.

Audit Committee Matching System

.105 The Audit Committee Matching System was designed to provide members with opportunities to serve on boards of directors and as a public service to provide a list of qualified, credentialed candidates to serve on boards of directors and presumably the audit committees of those boards. The AICPA's Audit Committee Effectiveness Center webpage at www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/Pages/ACEC.aspx also contains a link to the Audit Committee Matching System.

* * * * *

This Audit Risk Alert replaces *Understanding SAS No. 112 and Evaluating Control Deficiencies*.

As you encounter audit or industry issues that you believe warrant discussion in an AICPA Audit Risk Alert, please feel free to share them with us. Any other comments that you have about this Audit Risk Alert would also be appreciated. You may e-mail these comments to ccole@aicpa.org or write to

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AAM Section 9000 Accountants' Reports

These examples are for illustrative purposes only. They are included as conveniences for users of this manual who may want points of departure when drafting reports to meet their individual needs. This manual is a nonauthoritative kit of practice aids and, accordingly, does not include extensive explanation or discussion of authoritative pronouncements. Please 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 9100.

Examples that are assembled from illustrative reporting language set forth in Statements on Auditing Standards (SASs) and Statements on Standards for Accounting and Review Services include citation of the particular source and its location in AICPA *Professional Standards.*

References to Professional Standards. When referring to the professional standards, this manual cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, SAS No. 54, *Illegal Acts by Clients*, is referred to as AU section 317, *Illegal Acts by Clients* (AICPA, *Professional Standards*).

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AAM Section 9100

Format of Accountants' Reports

Report Preparation

.01 Firms usually develop standard policies and procedures for preparing and issuing reports. The following are some suggested report preparation policies that the auditor may consider:

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

  The Board of Directors
  XYZ Credit Union
  City, State Zip Code

- *Salutation.* A salutation is not typically included on the report.
- *Report signing.* The firm name is usually manually signed by the engagement partner. The words "Certified Public Accountants" may be excluded from the signature if they are a normal part of the firm's letterhead.
- *Report dating.* Audit reports should not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion.
  - — The date is typically presented at the bottom of the page along with the city and state, if it is not included in firm letterhead, as follows:

    City, State
    April 5, 20XX

  - — When a subsequent event disclosed in the financial statements occurs after the original date of the auditor's report but before the issuance of the related financial statements, the auditor may use dual dating or date the report as of the later date. The following illustrates dual dating:

    City, State
    February 26, 20XX, except for Note X, which the date is
    April 5, 20XX

- *Level of service.* The level of service performed and the nature of the report are typically outlined in the engagement letter. The letter should be revised for any significant changes from the original understanding with the client, such as in the event of a step-up or step-down in the level of service.
  - — The partner typically approves any step-up or step-down in level of service. A step-up in level of service may occur after obtaining a revised understanding with the client. The auditor may consider a step-down in level of service only after carefully evaluating the reasons for the change because the reasons for the change may also affect the report on lower levels of service. Limitations on the scope of an audit, for example, may also preclude issuing a review or compilation report.
  - — If more than one level of service is performed for financial statements of the same period (for example, compilation and audit), the financial statements need only be accompanied by the report on the highest level of service performed.

Reports on Audited Financial Statements

.02 Generally accepted auditing standards (GAAS) establish reporting responsibilities. Following are the four standards of reporting[1] stated in paragraph .02 of AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*):

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

b. The auditor must identify in the auditor's report those circumstances in which GAAP has not been consistently applied in the current period in relation to the preceding period.

c. When the auditor determines that informative disclosures are not reasonably adequate, the auditor must so state in the auditor's report.

d. The auditor must either express an opinion regarding the financial statements taken as a whole or state that an opinion cannot be expressed in the auditor's report. When the auditor cannot express an overall opinion, the auditor should state the reasons therefor in the auditor's report. In all cases where an auditor's name is associated with financial statements, the auditor should clearly indicate the character of the auditor's work, if any, and the degree of responsibility the auditor is taking in the auditor's report.

Standard Report

.03 The standard auditor's report prescribed by AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), may be used when the auditor has formed an opinion, based on the application of GAAS,[3] that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in accordance with GAAP. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. GAAP). It should state that the financial statements identified in the report were audited. A standard auditor's report for the presentation of comparative financial statements is illustrated in paragraph .01 of section 9210.

Modifications of the Standard Auditor's Report

.04 AU section 508 describes situations that may require auditors to modify the standard report and also provides illustrations of the appropriate modifying language. These modifications, which are discussed in greater depth subsequently, are as follows:

- *Explanatory language.* A wide variety of situations may arise that require a modification of the standard auditor's report, without affecting the expression of an unqualified opinion. Some of the more common of such situations are going-concern problems, part of the financial statements have been audited by another auditor, or a significant change in accounting principles. The explanatory paragraph for situations that do not affect the auditor's opinion may precede or follow the opinion paragraph, unless otherwise required by AU section 508.
- *Qualified opinion.* Qualified opinions result from two general categories of situations: scope limitations and departures from GAAP. A scope limitation arises when the auditor has been unable to perform all of the auditing procedures he or she believes are necessary to express an unqualified opinion on the financial statements. Financial statements containing a material departure from GAAP, including

[1] The reporting standards apply only when the auditor issues a report.

[2] When an auditor reports on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles (GAAP), the first standard of reporting is satisfied by stating in the auditor's report that the basis of presentation is a comprehensive basis of accounting other than GAAP and by expressing an opinion (or disclaiming an opinion) on whether the financial statements are presented in conformity with the comprehensive basis of accounting used.

[3] Paragraph .08 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), indicates that one of the basic elements of the standard report is an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards).

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inadequate disclosures in the financial statements, may lead the auditor to qualify his or her opinion. Both situations require an explanatory paragraph to be included, preceding the opinion paragraph, describing the nature of the scope limitation or the departure from GAAP.

- *Disclaimer of opinion.* A disclaimer of opinion is appropriate when
  - the scope of the audit has been restricted so significantly that the auditor does not have a basis for forming an opinion on the financial statements. In this case, an explanatory paragraph, preceding the disclaimer paragraph, should be included in the auditor's report to explain all significant reasons for the disclaimer.
  - the auditor is not independent, in which case a one paragraph disclaimer is issued (applies for issuers only). A compilation report with a lack of independence noted should be issued for nonissuers entities.
- *Adverse opinion.* An adverse opinion is expressed on financial statements that do not present fairly the entity's financial position, results of operations, or cash flows in conformity with GAAP. In other words, the auditor concludes that the financial statements are *not* fairly presented in accordance with GAAP. When the auditor expresses an adverse opinion, he or she should disclose in a separate explanatory paragraph, preceding the opinion paragraph, all of the substantive reasons for the adverse opinion and, if practical, the effects of the subject matter of the adverse opinion on the financial statements.

Scope Limitations

.05 Restrictions on the scope of an audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient competent audit evidence, or an inadequacy in the client's accounting records, may require a qualified opinion or a disclaimer of opinion. Deciding whether to qualify or disclaim is a matter of judgment, and generally the primary factor in this decision is the materiality of the financial statement items affected. However, other factors may be considered, such as the pervasiveness of the effects of the omitted auditing procedures and the nature of the financial statement items affected.

Departures From GAAP

.06 *Unacceptable Principles.* When financial statements are materially affected by a departure from GAAP, the auditor should express either a qualified or adverse opinion. Choosing between a qualified or adverse opinion depends on the magnitude of the departure. Although the materiality of the effects of the departure is a primary consideration, the auditor may also consider the pervasiveness of the departure (such as the number of financial statement items affected), the importance of the departure to the organization's activities and its ability to obtain funding, and the dollar effect of the departure on individual financial statement items as well as the statements as a whole.

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

.08 *Inadequate Disclosure.* Departures from GAAP include not just inappropriate application of accounting principles, but also omitted or inadequate disclosures in the financial statements. In such situations, the auditor should add an explanatory paragraph, preceding the opinion paragraph, that describes the nature of the inadequate or omitted disclosure and, if practical, the information that should have been disclosed. The significance of the omitted or inadequate disclosure will determine whether a qualified or adverse opinion is appropriate.

.09 *Report Modification.* The opinion paragraph for a qualified opinion due to a departure from GAAP should include the words *except* or *exception* and a reference to the explanatory paragraph that describes that departure. Adverse opinions should include language such as "do not present fairly" and should also include a reference to the explanatory paragraph. A qualified opinion indicating a departure from GAAP is presented in paragraph .02 of section 9240. An adverse opinion indicating a departure from GAAP is presented in paragraph .01 of section 9220.

Errors, Fraud, and Illegal Acts

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

.11 If a client will not accept modification of the report under the circumstances above, the firm may wish to consider withdrawing from the engagement and consulting with legal counsel.

Consistency Exceptions

.12 Accounting changes affecting consistency include the following:

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

.13 Accounting changes that do not normally affect consistency include the following:

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

.14 The nature of the accounting change will determine whether prior periods should be restated or a cumulative adjustment should be included in current activities. In either event, the change should be disclosed in the notes to the financial statements and in the auditor's report in a separate paragraph following the opinion paragraph. The auditor's concurrence with a change is implicit unless he or she takes exception to the change. The opinion paragraph would be standard unless the change is to an unacceptable principle or method, the change is not justified, or a prospective change of a principle requiring retroactive adjustment is not discussed. In such situations, either a qualified or adverse opinion should be issued.

Uncertainties

.15 Uncertainties are significant circumstances, events, or transactions affecting the financial statements, the outcome of which cannot be reasonably estimated. Uncertainties are a particularly complex area because they can result in a qualified or adverse opinion due to a departure from GAAP, a qualified opinion, or disclaimer due to a scope limitation. Uncertainties include, but are not limited to, contingencies covered by

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Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 450, *Contingencies*, and matters related to estimates covered by FASB ASC 275, *Risks and Uncertainties*.

.16 *Uncertainties Not Requiring Modification of the Opinion.* Paragraph .30 of AU section 508 states that when the auditor has concluded that sufficient audit evidence supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.17 *Scope Limitations.* If the auditor is unable to obtain sufficient audit evidence to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. In some ways, information about uncertainties may always be considered insufficient because it is dependent on future, unknown events. However, if the auditor determines that audit evidence did or does exist, but it is unavailable to him or her (for example, because the information was destroyed or management will not allow the auditor to have access to it), the auditor may consider modifying the report for a scope limitation.

.18 *Departures From GAAP.* Paragraph .45 of AU section 508 describes three categories of departures from GAAP involving risks or uncertainties:

- Inadequate disclosure
- Inappropriate accounting principles
- Unreasonable accounting estimates

.19 If the auditor concludes that a matter involving a risk or uncertainty is not adequately disclosed in the financial statements in conformity with GAAP, the auditor should express a qualified or adverse opinion.

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

.21 *Going-Concern Uncertainties.* If the auditor concludes that there is substantial doubt about the organization's ability to continue as a going concern, the situation should be described in an explanatory paragraph, following the opinion paragraph. The explanatory paragraph may describe the principal events and conditions related to the going concern, their possible effects on the financial statements, management's plans for corrective actions, and the auditor's conclusion that substantial doubt exists. Paragraphs .12–.13 of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*), imposes the additional requirement that the explanatory paragraph include the terms *substantial doubt* and *going concern*. The auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern in the going concern explanatory paragraph.

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

Reporting on Supplementary Information

.23 Supplementary information includes detailed schedules of other data that are not necessary for a fair presentation of the basic financial statements. Whenever supplementary information is included in an auditor submitted document, the auditor has a responsibility to report on all of the information included in the document. A separate report on the supplementary information or a separate paragraph in the report on the basic financial statements may be used to report on supplementary information. If a separate report is issued, it may be on the firm's letterhead and should be signed. The report date should be the same as for the basic financial statements.

.24 Reports on supplementary information should express or disclaim audit assurance. The nature of the engagement and the extent and results of testing of supplementary information will determine the firm's responsibility in each circumstance. If a separate report on the supplemental information is issued, the first sentence of that report may refer to the report on the basic financial statements.

Reporting on a Single Statement

.25 In certain circumstances, an engagement to audit a single financial statement may be accepted. Generally these engagements, called *limited reporting engagements*, are a result of the client needing a single financial statement to fulfill a contractual requirement, such as an organization that must provide its landlord with an audited income statement for purposes of calculating rent. Also, entities that have never been audited often request an audit of the statement of financial position only for the first year, with the intention of having audits of the entire financial statements in the future. Generally such engagements are accepted as long as there is a legitimate reason for the limited engagement and provided that there are no restrictions on access to information underlying the financial statements or on the scope of the procedures the auditor needs to perform. In such engagements, an unqualified opinion may be expressed on the financial statement the auditor was engaged to audit. If the other financial statements are presented, a disclaimer of opinion may be issued on those statements. An unqualified opinion on a single statement audit is presented in paragraph .03 of section 9210.

Relying on the Work of a Specialist

.26 The firm may engage specialists to perform certain work supporting representations in the financial statements. AU section 336, *Using the Work of a Specialist* (AICPA, *Professional Standards*), indicates that if a review of the specialist's work finds it satisfactory, and if no report modification is necessary because of the specialist's findings, the auditor should not refer to the specialist's work.

.27 If the specialist's work is not adequate to support the financial statement representations, a qualification or disclaimer of opinion because of a scope limitation may be appropriate. Findings of the specialist that indicate the financial statements are not in accordance with GAAP may necessitate a qualified or adverse opinion.

Lack of Independence

.28 For issuers, whenever the auditor is not independent with respect to a client whose financial statements have been audited, a disclaimer of opinion should be issued. The Public Company Accounting Oversight Board (PCAOB), through PCAOB Rule 3600T, *Interim Independence Standards* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), has provisionally designated Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .01), of the AICPA Code of Professional Conduct, and interpretations and rulings thereunder, as they existed on April 16, 2003. Independence Standards Board (ISB) Standard No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*, ISB Standard No. 3, *Employment with Audit Clients*, and ISB Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)* (AICPA, *PCAOB Standards and Related Rules*, Interim Standards), provide interim independence standards for registered public accounting firms performing audits of issuers. The PCAOB's interim independence rules do not supersede the independence rules of the Securities and Exchange Commission (SEC). Therefore, to the extent that a provision of the SEC's rule or policy is more restrictive—or less restrictive—than the PCAOB's interim independence standards, a registered public accounting firm must comply with the more restrictive requirement. For nonissuers, the firm may only issue a compilation report that includes a statement that the firm is not independent.

.29 PCAOB Rule 3525, *Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), provides guidance related to the auditor's responsibilities when seeking audit committee preapproval of internal control related nonaudit services. The rule is intended to ensure that audit committees are provided relevant information for

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them to make an informed decision on how the performance of internal control-related services may affect independence. Specifically, the public accounting firm shall describe, in writing, the scope of the service and submit to the audit committee, as well as discuss with the audit committee the potential effects of the service on the firm's independence. Issuers are also required to document the substance of such discussions in writing. The full text of this rule can be found at http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx#rule3525.

.30 PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board), which builds on ISB Standard No. 1, provides that before accepting a new audit engagement and annually thereafter the auditor must describe in writing to the audit committee all relationships between the auditor and the client (including affiliates of both) that reasonably could be thought to bear on independence. The auditor must also discuss these matters with the audit committee, and document the substance of that discussion. The full text of this rule can be found at http://pcaobus.org/Rules/PCAOBRules/Pages/Section_3.aspx#rule3526.

Reissuance of Audit Reports as Predecessors

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

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

- Read the financial statements of the current period.
- Compare the prior-period financial statements with the financial statements to be presented in comparative format by the successor.
- Obtain a letter of representation from the management of the former client and successor auditor. The representation letter from management of the former client should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance sheet date of the latest prior period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements.[4] The successor should represent that his or her audit has not revealed any matters that may have a material effect on the prior period financial statements.

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

[4] See appendix C, "Illustrative Updating Management Representation Letter," paragraph .18 of AU section 333, *Management Representations* (AICPA, *Professional Standards*).

Reissuance of the Audit Report Subsequent to the Date of Original Issue[5]

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

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

Subsequent Discovery of Facts Existing at Report Date

.36 Although the auditor has no obligation to make any continuing inquiries or perform other procedures after issuing his or her report, the auditor may become aware of information that affects the financial statements upon which he or she has previously reported. When becoming aware of such information, the auditor should determine the reliability of the information and whether such information existed at the date of the report. The auditor should make inquiries of client management in this regard.

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

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

.38 If the client refuses to make the disclosures discussed in the preceding paragraph, the auditor may wish to contact legal counsel. He or she should also notify all members of the board of directors of such refusal. The firm will take the following steps to prevent future reliance on its report:

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

[5] The AICPA Auditing Standards Board Interpretation No. 1, "Eliminating a Going-Concern Explanatory Paragraph From a Reissued Report," of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, AU sec. 9341 par. .01–.02), provides guidance regarding situations when a previously issued report contains a going-concern explanatory paragraph, and the situation that gave rise to the going-concern has been resolved.

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.39 If the auditor's investigation of the subsequently discovered information is satisfactory, and he or she has determined that the information is reliable, the notifications in paragraph .36 should include a description of the effects of the information on the financial statements. If the client has not cooperated and, as a result, the auditor has been unable to conduct a satisfactory investigation, the auditor does not need to indicate the details of the information. Instead, the auditor can merely indicate that information has come to his or her attention that his or her client has not cooperated in attempting to substantiate, and that, if the information is true, the auditor believes that his or her report must no longer be relied upon nor should the auditor be associated with the financial statements.

[*The next page is 9211.*]

AAM Section 9210

Unqualified Opinions

.01 Auditor's Standard Report—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*)]

.02 Auditor's Standard Report—Single Year Financial Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 508]

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.03 Report on a Single Statement Audit (Balance Sheet Only Presented) [Assuming the Auditor is Able to Satisfy Himself or Herself Regarding the Consistency of Application of Accounting Principles]

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX. This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit.

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

In our opinion, the balance sheet referred to above, presents fairly, in all material respects, the financial position of X Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .34 of AU section 508]

Note: If reporting on a single statement (for example, balance sheet only) when other financial statements are also presented, the following paragraph may be added after the opinion paragraph:

> Because we were not engaged to audit the statements of income, retained earnings, and cash flows, we did not extend our auditing procedures to enable us to express an opinion on the results of operations and cash flows for the year ended December 31, 20XX. Accordingly, we express no opinion on them.

.04 Reference to Other Auditors—Successor Auditor's Report When Predecessor's Report (Unqualified) Is Not Presented

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

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

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .74 of AU section 508]

Practice Tip

(1) The successor auditor should not name the predecessor auditor in his or her report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor.

[Source: Paragraph .74 footnote 29 of AU section 508]

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.05 Reference to Other Auditors in Report

Independent Auditor's Report

Addressee:

We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_______ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_______ and $_______ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

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

In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .13 of AU section 508]

.06 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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

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

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .74 of AU section 508]

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.07 Reference to Other Auditors—Successor Auditor's Report When Prior Year Financial Statements Have Been Restated Following Issuance of the Predecessor's Report

Independent Auditor's Report

Addressee:

We have audited the balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, before the restatement described in Note X, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

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

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.[1]

[*Signature*]

[*Date*]

[Source: Paragraph .74 of AU section 508]

[1] This paragraph may be added to the report when the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself to the appropriateness of the restatement adjustments.

.08 Reference to Other Auditors—Prior Year Financial Statements Restated Following a Pooling of Interests

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We previously audited and reported on 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 on separately by other auditors. We also audited the combination of the accompanying consolidated statements of income and cash flows for the year ended December 31, 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: Paragraph .08 of AU section 508 and paragraph .16 of AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*)]

Note: This report is used when the auditor concludes that he or she cannot serve as principal auditor for the restated financial statements.

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.09 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited by a Predecessor Auditor Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

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

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 508 and paragraph .61 of Interpretation No. 15, "Reporting as Successor Auditor When Prior-Period Audited Financial Statement Were Audited by a Predecessor Auditor Who Has Ceased Operations," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .60–.75)]

.10 Reference to Other Auditors—Successor Auditor Report When Prior Period Financial Statements Were Audited By a Predecessor Auditor Who Has Ceased Operations Have Been Restated

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, and for the year then ended, before the restatement described in Note X, were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

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

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.[2]

[*Signature*]

[*Date*]

[Source: Paragraph .74 of AU section 508 and paragraphs .61–.63 and .66 of Interpretation No. 15 of AU section 508]

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[2] See footnote 1.

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.11 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Reviewed by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were reviewed by other accountants who have ceased operations, and their report thereon, dated March 1, 20X2, stated they were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: Paragraph .17 of AU section 504, *Association with Financial Statements* (AICPA, *Professional Standards*), paragraph .74 of AU section 508, and paragraph .66 of Interpretation No. 15 of AU section 508]

.12 Reference to Other Accountants—Report on Nonpublic Entity Presented With Prior Period Financial Statements Compiled by a Predecessor Accountant Who Has Ceased Operations

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were compiled by other accountants who have ceased operations, and their report thereon, dated February 1, 20X2, stated that they did not audit or review those financial statements and, accordingly, express no opinion or any other form of assurance on them.

[*Signature*]

[*Date*]

[Source: Paragraph .17 of AU section 504, paragraph .74 of AU section 508, and paragraph .66 of Interpretation No. 15 of AU section 508]

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.13 Change in Accounting Principles or Method of Accounting

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, the Company changed its method of computing depreciation in 20XX.

[*Signature*]

[*Date*]

[Source: Paragraphs .08 and .17 of AU section 508]

.14 Going Concern—Uncertainty

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 508 and paragraph .13 of AU section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*)]

Note: In a going-concern explanatory paragraph, the auditor should not use conditional language in expressing a conclusion concerning the existence of substantial doubt about the entity's ability to continue as a going concern.

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.15 Liquidation Basis of Accounting—Single Year Financial Statements

Independent Auditor's Report

Addressee:

We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of XYZ Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph.

[*Signature*]

[*Date*]

[Source: Paragraph .36 of Interpretation No. 8, "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .33–.37)]

.16 Liquidation Basis of Accounting—Comparative Financial Statements

Independent Auditor's Report

Addressee:

We have audited the balance sheet of XYZ Company as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2. In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material 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.

As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph.

[*Signature*]

[*Date*]

[Source: Paragraph .36 of Interpretation No. 8 of AU section 508]

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.17 Comparative Financial Statements—Unqualified Opinion on the Current Year's Financial Statements With Disclaimer of Opinion on the Prior Year's Statements of Income, Retained Earnings, and Cash Flows

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

In our opinion, the balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraphs .08 and .67 of AU section 508]

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.

.18 Comparative Financial Statements—Subsequent Restatement of Prior-Period Financial Statements to Conform With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraphs .08 and .69 of AU section 508]

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.19 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, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were reviewed by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) were not aware of any material modifications that should be made to those statements for them to be in conformity with generally accepted accounting principles. However, a review is substantially less in scope than an audit and does not provide a basis for the expression of an opinion on the financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 508 and paragraph .17 of AU section 504]

Notes: When unaudited financial statements are presented in comparative form with audited financial statements, the unaudited financial statements should be clearly marked to indicate their status.

When the financial statements are those of a public entity, the separate paragraph should include a disclaimer of opinion or a description of a review. (A sample of a disclaimer of opinion is provided in paragraph .21.)

.20 Comparative Financial Statements—Current Year's Statements Audited and Prior Year's Statements Compiled

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The 20X1 financial statements were compiled by us (other accountants) and our (their) report thereon, dated March 1, 20X2, stated we (they) did not audit or review those financial statements and, accordingly, express no opinion or other form of assurance on them.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 508 and paragraph .17 of AU section 504]

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.

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.21 Comparative Financial Statements—Current Year's Statements Audited and Disclaimer on Prior Year's Unaudited Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying balance sheet of X Company as of December 31, 20X1, and the related statements of income, retained earnings, and cash flows for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 508 and paragraphs .05 and .17 of AU section 504]

Notes: The preceding report illustrates a disclaimer of opinion as described in paragraphs .05 and .17 of AU section 504 when the financial statements are those of a public entity. For a nonpublic entity, see paragraphs .19–.20 in this section.

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.

.22 U.S.-Style Report Modified to Report on Financial Statements Prepared in Conformity With Accounting Principles Generally Accepted in Another Country That Are Intended for Use Only Outside the United States

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 20XX and the related statements of income, retained earnings, and cash flows for the year then ended which, as described in Note X, have been prepared on the basis of accounting principles 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 of America (and in [*name of country*]). U.S. standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of International Company as of [*at*] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in [*name of country*].

[*Signature*]

[*Date*]

[Source: Paragraph .10 of AU section 534, *Reporting on Financial Statements Prepared for Use in Other Countries* (AICPA, *Professional Standards*)]

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.23 Report on Financial Statements Prepared in Conformity With the Accounting Principles Generally Accepted in Another Country That Will Have More Than Limited Distribution in the United States

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of International Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

As described in Note X to the financial statements, the Company has recorded fixed assets in excess of historical cost using appraised value as the basis for adjustment in accordance with accounting principles generally accepted in [*name of country*]. If the fixed assets had been recorded at historical cost, fixed assets and retained earnings would be decreased by $XXX,XXX and $XXX,XXX respectively, as of December 31, 20XX, and net income and earnings per share would be increased by $X,XXX and $X.XX respectively for the year then ended.

In our opinion, except for the effects of recording the fixed assets in excess of historical costs, discussed in the preceding paragraph, the financial statements present fairly, in all material respects, the financial position of International Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

(Optional Paragraph)

In our opinion, the financial statements referred to above present fairly the financial position of International Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended, in conformity with accounting principles generally accepted in [*name of country*].

[*Signature*]

[*Date*]

[Source: Paragraphs .08 and .35–.57 of AU section 508 and paragraphs .14–.15 of AU section 534]

> ***Note:*** This report does not apply to reports on financial statements of U.S. subsidiaries of foreign registrants presented in Securities and Exchange Commission filings of foreign parent companies where the subsidiaries' financial statements have been prepared on the basis of accounting used by the parent company.

.24 Correction of an Error, Not Involving an Accounting Principle

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, certain errors resulting in an understatement of previously reported expenses for the years ended December 31, 20X1 and 20X0 were discovered by the Company's management during the current year. Accordingly, the 20X1 financial statements have been restated and an adjustment has been made to retained earnings as of January 1, 20X1 to correct the errors.

[*Signature*]

[*Date*]

[Sources: Paragraph .08 of AU section 508 and paragraph .12 of AU section 420, *Consistency of Application of Generally Accepted Accounting Principles* (AICPA, *Professional Standards*)]

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 (paragraph .06[*b*]) of AU section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* [AICPA, *Professional Standards*]).

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.25 Subsequent Event Prior to Issuance of Auditor's Report

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note X to the financial statements, on March 1, 20X3, the Company entered into an agreement to sell Subsidiary A. This Subsidiary represents X percent of the Company's total assets and X percent of its revenues.

[*Signature*]

[*Date*]

[Source: Paragraphs .08 and .19 of AU section 508]

.26 Reissued Report Due to Subsequent Discovery of Facts Existing at the Date of the Auditor's Report

Independent Auditor's Report

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 10 to the financial statements, the Company's 20X2 [*specify account corrected*] previously reported as $XX,XXX should have been $X,XXX. This discovery was made subsequent to the issuance of the financial statements. The financial statements have been restated to reflect this correction.

[*Signature*]

[*March 31, 20X3, except for Note 10, as to which the date is April 30, 20X3*]

[Sources: Paragraph .06(*a*) of AU section 561 and paragraph .08 of AU section 508]

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.27 Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X4, and the related statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. *An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.* An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .88 of Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88)]

Note: The additional language related to internal control should not be used when reporting on the audit of financial statements of a nonissuer that engages its auditor to examine (or audit) and report on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.

.28 Reference to Public Company Accounting Oversight Board Standards in an Audit Report on a Nonissuer

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of XYZ Company as of December 31, 20X4, and the related statements of income and retained earnings and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with *generally accepted auditing standards as established by the Auditing Standards Board (United States) and in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States).* Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. *The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting.Accordingly we express no such opinion.* An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X4, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .92 of Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92)]

Note: This example includes the illustrative language from paragraph .88 of AU section 9508. Because the Public Company Accounting Oversight Board's (PCAOB) Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting that is Integrated With An Audit of Financial Statements* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), requires an audit of internal control for those entities that are subject to Section 404(a) of the act, an audit of a nonissuer performed under PCAOB auditing standards does not require an audit of internal control unless otherwise required by a regulator with jurisdiction over the nonissuer. The additional language related to internal control should not be used when reporting on the audit of financial statements of a nonissuer that engages its auditor to examine (or audit) and report on the effectiveness of internal control over financial reporting either voluntarily or to comply with regulatory requirements.

[*The next page is 9271.*]

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AAM Section 9220

Adverse Opinions

.01 Departures From Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_______ and $_______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_______ and $_______ in excess of an amount based on the cost to the Company; and deferred income taxes of $_______ and $_______ have not been recorded; resulting in an increase of $_______ and $_______ in retained earnings and in appraisal surplus of $_______ and $_______, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_______ and $_______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_______ and $_______ have not been provided, resulting in an increase in net income of $_______ and $_______, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

[*Signature*]

[*Date*]

[Source: Paragraph .60 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*)]

[*The next page is 9321.*]

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AAM Section 9230

Disclaimers of Opinion

.01 Beginning Inventory Not Observed (First Examination)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheet of X Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.[1]

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

Because we were not engaged as auditors until after December 31, 20X1, we were not present to observe the physical inventory taken at that date and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities. Accordingly, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the accompanying statements of income, retained earnings and cash flows for the year ended December 31, 20X2.

In our opinion, the balance sheet referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .26 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*)]

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[1] Although the introductory paragraph of the standard disclaimer of opinion begins with "We were engaged to audit ..." and the scope paragraph of the report is omitted, paragraph .67 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*), shows that the introductory paragraph does not need to be modified nor does the scope paragraph need to be omitted when the disclaimed financial statements are with audited financial statements.

.02 Inability to Obtain Sufficient Competent Evidential Matter Due to a Scope Limitation

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.[2]

[*Second paragraph of standard report should be omitted*]

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_______ as of December 31, 20X2, and at $________ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

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

[*Signature*]

[*Date*]

[Source: Paragraph .63 of AU section 508]

[2] The wording in the first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with generally accepted auditing standards. In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor's responsibility to express an opinion.

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.03 Scope Limitation—Inventory and Generally Accepted Accounting Principles Departure—Capitalized Lease Obligations

Independent Auditor's Report

Addressee:

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_______ as of December 31, 20X2, and at $________ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

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

[*Signature*]

[*Date*]

[Source: Paragraphs .39 and .63 of AU section 508]

Note: This report would be used if the generally accepted accounting principles departure is not so material to require an adverse opinion. See paragraph .01 of section 9220 for an example of an adverse opinion.

[*The next page is 9371.*]

AAM Section 9240

Qualified Opinions

.01 Scope Limitation—Investment in Foreign Affiliate (Assuming Effects Are Such That Qualification Rather Than Disclaimer Is Appropriate)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above, present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .26 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*)]

.02 Departure From Generally Accepted Accounting Principles (GAAP)—Leases Not Capitalized

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .39 of AU section 508]

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.03 Departure From GAAP—Leases Not Capitalized—Pertinent Facts Disclosed in Note

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .40 of AU section 508]

.04 Inadequate Disclosure—Omission of Disclosures

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

The Company's financial statements do not disclose [*describe the nature of the omitted information that it is not practicable to present in the auditor's report*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .42 of AU section 508]

Note: This report assumes the effects are such that the auditor has concluded an adverse opinion is not appropriate.

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.05 Inadequate Disclosure—Omission of Statement of Cash Flows

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .44 of AU section 508]

.06 Change in Accounting Principle Without Reasonable Justification

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification for making this change as required by those principles.

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .52 of AU section 508]

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 concerning consistency. However, because the middle paragraph contains all of the information required in an explanatory paragraph (following the opinion paragraph) as required by paragraphs .16–.18 of AU section 508, an explanatory paragraph is not required in this instance.

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.07 Change to an Accounting Principle Not in Conformity With Generally Accepted Accounting Principles

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

The company previously recorded its land at cost but adjusted the amounts to appraised values during the year, with a corresponding increase in stockholders' equity in the amount of $_____. In our opinion, the new basis on which land is recorded is not in conformity with accounting principles generally accepted in the United States of America.

In our opinion, except for the change to recording appraised values as described above, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .55 of AU section 508]

.08 More than One Reason—Qualified Opinion on Prior Year's Financial Statements With the Current Year Qualified for the Same Reason and an Additional Reason

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

In our opinion, except for the effects on the 20X2 and 20X1 financial statements of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, and except for the effects of the 20X2 financial statements of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraphs .26 and .39 of AU section 508]

[*The next page is 9421.*]

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AAM Section 9245

Information Accompanying Audited Financial Statements[*]

.01 Omission of Supplementary Information Required by the Financial Accounting Standards Board (FASB)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has not presented [*describe the supplementary information required by generally accepted accounting principles (GAAP)*[1]] that accounting principles generally accepted in the United States has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*)[*]]

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[*] In February 2010, the Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 118, *Other Information in Documents Containing Audited Financial Statements*; SAS No. 119, *Supplementary Information in Relation to the Financial Statements as a Whole*; and SAS No. 120, *Required Supplementary Information* (AICPA, *Professional Standards*, AU sec. 550, 551, and 558). These standards amend or supersede AU section 550A, *Other Information in Documents Containing Audited Financial Statements*; AU section 551A, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and AU section 558A, *Required Supplementary Information* (AICPA, *Professional Standards*), respectively. Collectively, these statements address the auditor's responsibilities with respect to information that is required by a designated standard setter (for example, the Financial Accounting Standards Board [FASB], Governmental Accounting Standards Board [GASB], Federal Accounting Standards Advisory Board, and the International Accounting Standards Board) to accompany an entity's basic financial statements and supplementary information that is presented outside the basic financial statements. The effective date of the SASs is for audits of financial statements for periods beginning on or after December 15, 2010, and early application is permitted.

[1] The auditor may identify the body requiring the information, such as FASB in this example.

.02 Omission of Supplementary Information Required by the Governmental Accounting Standards Board (GASB)[2]

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][3] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.[4]

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[2] See subparagraph A-1 of paragraph 14.79 in the AICPA Audit and Accounting Guide *State and Local Governments* for conditions that may make modifications to this report necessary, such as when the financial statements include information from a prior period.

[3] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. (This wording may be added even in a report on the financial statements in an audit conducted in accordance with *Government Auditing Standards* or U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, in which the auditor reports on internal control over financial reporting but does not express an opinion on that internal control. See the AICPA Audit Guide Government Auditing Standards *and Circular A-133 Audits*.) Interpretation No. 17 addresses how auditors may expand this report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional wording is added, the remainder of the paragraph would read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

[4] If a government presents required budgetary comparison information as basic financial statements instead of as required supplementary information (RSI), the opinion paragraph would be replaced with the following:

> In our opinion, the financial statements referred to previously present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the [*indicate the major governmental funds involved*] for the year then ended in conformity with accounting principles generally accepted in the United States of America.

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The City of Example, Any State, has not presented [*describe the supplementary information required by GAAP*[5]] that accounting principles generally accepted in the United States of America has determined is necessary to supplement, although not required to be part of, the basic financial statements.

[*Signature*]

[*Date*]

[Sources: Paragraph .08 of AU section 558A;[*] AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011, paragraph 14.79 (appendix A example A-1)]

[5] The auditor may identify the body requiring the information, such as GASB in this example.

[*] See footnote * in section title.

.03 Material Departures From FASB Guidelines for Required Supplementary Information

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with accounting principles generally accepted in the United States because [*describe the material departure(s) from the GAAP*[6]].

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 558A[*]]

Note: Ordinarily, the required supplementary information (RSI) should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the RSI outside the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report on the audited financial statements should be expanded to include a disclaimer on the supplementary information.

[Source: Paragraph .11 of AU section 558A[*]] (See paragraph .10 of this section.)

[6] See footnote 1.

[*] See footnote * in section title.

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.04 Material Departures From GASB Guidelines for Required Supplementary Information[7]

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][8] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.[9]

The [*specifically identify the supplementary information*] on pages XX through XX and XX through XX are not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the supplementary information. As a result of such limited procedures, we believe that the [*specifically identify the supplementary information*] is not in conformity with accounting principles generally accepted in the United States because [*describe the material departure(s) from GAAP*[10]].

[*Signature*]

[*Date*]

[Sources: Derived from paragraph .08 of AU section 558A;[*] AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011, paragraphs 14.56 and 14.79 (appendix A example A-1)]

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[7] See footnote 2.

[8] See footnote 3.

[9] See footnote 4.

[10] See footnote 5.

[*] See footnote * in section title.

Note: GASB standards require the management's discussion and analysis, which is RSI, to precede the basic financial statements and most other RSI (that is, budgetary comparison information, information related to pension and other postemployment benefits, and information on assessed condition and estimated and actual maintenance and preservation costs for governments that use the modified approach for infrastructure assets) to be presented immediately following the notes to the financial statements. Although paragraph .11 of AU section 558A discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB RSI given the GASB's specific requirements for placement. If a government does not place GASB RSI in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines.

[Source: AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011, paragraph 2.62]

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.05 Prescribed Procedures Not Completed Regarding Supplementary Information Required by FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 558A[*]]

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on a basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: Paragraph .08 of AU section 558A[*]]

Ordinarily, the RSI should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the RSI outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information. [Source: Paragraph .11 of AU section 558A[*]] (See paragraph .10 in this section.)

[*] See footnote * in section title.

.06 Prescribed Procedures Not Completed Regarding Supplementary Information Required by GASB[11]

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][12] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.[13]

The [*specifically identify the supplementary information*] on pages XX through XX and XX through XX are not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. Further, we were unable to apply to the information certain procedures prescribed by professional standards because [*state the reasons*].

[*Signature*]

[*Date*]

[Sources: Paragraph .08 of AU section 558A;[*] AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011, paragraph 14.79 (appendix A example A-1)]

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[11] See footnote 2.

[12] See footnote 3.

[13] See footnote 4.

[*] See footnote * in section title.

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Notes: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: Paragraph .08 of AU section 558A*]

GASB standards require the management's discussion and analysis, which is RSI, to precede the basic financial statements and most other RSI (that is, budgetary comparison information, information related to pension and other postemployment benefits, and information on assessed condition and estimated and actual maintenance and preservation costs for governments that use the modified approach for infrastructure assets) to be presented immediately following the notes to the financial statements. Although paragraph .11 of AU section 558A* discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB RSI given the GASB's specific requirements for placement. If a government does not place GASB RSI in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines. [Source: AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011, paragraph 2.62]

* See footnote * in section title.

.07 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by FASB

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*specifically identify the supplementary information*] on page XX is not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States. [*The auditor should consider including in the report the reason(s) he or she was unable to resolve his or her substantial doubts.*]

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 558A*]

Note: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report.

[Source: Paragraph .08 of AU section 558A*]

Ordinarily, the RSI should be distinct from the audited financial statements and distinguished from other information outside the financial statements that is not required by GAAP. However, management may choose not to place the RSI outside of the basic financial statements. In such circumstances, unless it is audited as part of the basic financial statements, the information should be clearly marked as unaudited. If the information is not clearly marked as unaudited, the auditor's report should be expanded to include a disclaimer on the supplementary information.

[Source: Paragraph .11 of AU section 558A*] (See paragraph .10 in this section.)

* See footnote * in section title.

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.08 Unresolved Doubts About Adherence to Guidelines Regarding Supplementary Information Required by GASB[14]

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][15] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.[16]

The [*specifically identify the supplementary information*] on pages XX through XX and XX through XX are not a required part of the basic financial statements, and we did not audit and do not express an opinion on such information. However, we have applied certain limited procedures prescribed by professional standards that raised doubts that we were unable to resolve regarding whether material modifications should be made to the information for it to conform with guidelines established by accounting principles generally accepted in the United States. [*The auditor should consider including in the report the reason(s) he or she was unable to resolve his or her substantial doubts.*]

[*Signature*]

[*Date*]

[Sources: Paragraph .08 of AU section 558A;[*] AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011, paragraph 14.79 (appendix A example A-1)]

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[14] See footnote 2.

[15] See footnote 3.

[16] See footnote 4.

[*] See footnote * in section title.

Notes: Even though the auditor is unable to complete the prescribed procedures, if, on the basis of facts known to him or her, the auditor concludes that the supplementary information has not been measured or presented within prescribed guidelines, he or she should suggest appropriate revision; failing that, he or she should describe the nature of any material departure(s) in the report. [Source: Paragraph .08 of AU section 558A*]

GASB standards require the management's discussion and analysis, which is RSI, to precede the basic financial statements and most other RSI (that is, budgetary comparison information, information related to pension and other postemployment benefits, and information on assessed condition and estimated and actual maintenance and preservation costs for governments that use the modified approach for infrastructure assets) to be presented immediately following the notes to the financial statements. Although paragraph .11 of AU section 558A* discusses alternative placement of RSI provided it is clearly marked as unaudited, that alternative is not available for GASB RSI given the GASB's specific requirements for placement. If a government does not place GASB RSI in its financial report as required by GASB standards, the auditor should consider the effect of the placement on his or her report. Specifically, the auditor should consider whether to report that the RSI placement constitutes a presentation that departs materially from prescribed guidelines.

[Source: AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011, paragraph 2.62.]

* See footnote * in section title.

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.09 Report on Accompanying Information

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The (identify accompanying information) is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: Paragraph .12 of AU section 551A,[*] *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*)]

> ***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.
>
> [Source: Paragraph .06 of AU section 551A[*]]

[*] See footnote * in section title.

.10 Disclaimer on Accompanying Information (Not Audited)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The [*identify the accompanying information*] is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

[*Signature*]

[*Date*]

[Source: Paragraph .13 of AU section 551A*]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

[Source: Paragraph .06 of AU section 551A*]

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he or she submits to his or her client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

[Source: Paragraph .13 of AU section 551A*]

* See footnote * in section title.

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.11 Disclaimer on Part of the Accompanying Information (Not Audited)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information on pages XX-YY is presented for purposes of additional analysis and is not a required part of the basic financial statements. Such information, except for that portion marked "unaudited," on which we express no opinion, has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, the information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: Paragraph .13 of AU section 551A[*]]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.

[Source: Paragraph .06 of AU section 551A[*]]

When the auditor disclaims an opinion on all or part of the accompanying information in a document that he or she submits to his or her client or to others, such information should either be marked as unaudited or should include a reference to the auditor's disclaimer of opinion. The wording of the disclaimer will vary according to the circumstances.

[Source: Paragraph .13 of AU section 551A[*]]

[*] See footnote * in section title.

.12 Qualification on Basic Financial Statements and Accompanying Information (Departure From GAAP)

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The schedules of property and related depreciation (page X), and long-term debt with related interest (page Y), as of December 31, 20X2, and 20X1, are presented for purposes of additional analysis and are not a required part of the basic financial statements. The information in such schedules has been subjected to the auditing procedures applied in the audit of the basic financial statements; and, in our opinion, except for the effects on the schedule of property of not capitalizing certain lease obligations as explained in the third paragraph of this report, such information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

[*Signature*]

[*Date*]

[Sources: Paragraph .14 of AU section 551A* and paragraph .39 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*)]

> ***Note:*** The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document.
>
> [Source: Paragraph .06 of AU section 551A*]

* See footnote * in section title.

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.13 Supplementary Information Required by FASB Included in Auditor-Submitted Document

Independent Auditor's Report

Addressee:

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above, present fairly, in all material respects, the financial position of X Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by accounting principles generally accepted in the United States of America.[17] 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: Paragraph .15 of AU section 551A[*]]

Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in the auditor-submitted document. [Source: Paragraph .06 of AU section 551A[*]]

When supplementary information required by GAAP is presented outside the basic financial statements in an auditor-submitted document, the auditor should (*a*) express an opinion on the information if the auditor has been engaged to examine the information, (*b*) report on the information using the guidance in paragraphs .12 and .14 of AU section 551A, provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (*c*) disclaim an opinion on the information.[18] [Source: Paragraph .15 of AU section 551A[*]]

In certain circumstances, the auditor's report should be expanded in accordance with paragraphs .08–.09 of AU section 558A. The illustrative reports in paragraphs .01–.08 in this section are assembled from illustrative reporting language in paragraph .08 of AU section 558A.

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[17] See footnote 1.

[*] See footnote * in section title.

[18] The guidance in (*b*) applies to GASB RSI, such as that required by GASB Statement No. 5, *Disclosure of Pension Information by Public Employee Retirement Systems and State and Local Governmental Employers*. Paragraphs .09–.10 of AU section 552, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*), provide an example of a report on GASB RSI.

.14 Supplementary Information Required by GASB Included in Auditor-Submitted Documents[19]

Independent Auditor's Report

Addressee:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of and for the year ended June 30, 20X1, which collectively comprise the City's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the City of Example's management. Our responsibility is to express opinions on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the City's internal control over financial reporting. Accordingly, we express no such opinion.*][20] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the City of Example, Any State, as of June 30, 20X1, and the respective changes in financial position, and, where applicable, cash flows thereof for the year then ended in conformity with accounting principles generally accepted in the United States of America.[21]

The [*identify accompanying required supplementary information*] on pages XX through XX and XX through XX are not a required part of the basic financial statements but are supplementary information required by accounting principles generally accepted in the United States of America.[22] We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

[*Signature*]

[*Date*]

[Sources: Paragraph .15 of AU section 551A;[*] AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011, paragraph 14.79 (appendix A example A-1)]

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[19] See footnote 2.
[20] See footnote 3.
[21] See footnote 4.
[22] See footnote 5.
[*] See footnote * in section title.

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Notes: The report on the accompanying information may be added to the auditor's standard report on the basic financial statements or may appear separately in auditor-submitted documents. [Source: Paragraph .06 of AU section 551A[*]]

When supplementary information required by GAAP is presented outside the basic financial statements in an auditor-submitted document, the auditor should (*a*) express an opinion on the information if the auditor has been engaged to examine the information, (*b*) report on the information using the guidance in paragraphs .12 and .14 of AU section 551A), provided such information has been subjected to the auditing procedures applied in the audit of the basic financial statements, or (*c*) disclaim an opinion on the information.[23] [Source: Paragraph .15 of AU section 551A[*]]

In certain circumstances, the auditor's report should be expanded in accordance with paragraphs .08–.09 of AU section 558A. The illustrative reports at paragraphs .01–.08 in this section are assembled from illustrative reporting language in paragraph .08 of AU section 558A and the AICPA Audit and Accounting Guide *State and Local Governments*, updated as of March 1, 2011.

[*] See footnote in section title.

[23] The guidance in (*b*) applies to GASB RSI, such as that required by GASB Statement No. 5. Paragraphs .09–.10 of AU section 552 provide an example of a report on GASB RSI.

.15 Consolidating Information Not Separately Audited

Independent Auditor's Report

Addressee:

We have audited the accompanying consolidated balance sheets of X Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company and subsidiaries as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Our audits were conducted for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The consolidating information is presented for purposes of additional analysis of the consolidated financial statements rather than to present the financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

[*Signature*]

[*Date*]

[Source: Paragraph .19 of AU section 551A[*]]

Notes: The report on the consolidating information may be added to the auditor's report on the basic financial statements or may appear separately in the auditor-submitted document.

[Source: Paragraph .06 of AU section 551A[*]]

When the auditor is engaged to express an opinion only on the consolidated financial statements and consolidating information is also included, the auditor should be satisfied that the consolidating information is suitably identified. For example, when the consolidated financial statements include columns of information about the components of the consolidated group, the balance sheets might be titled, "Consolidated Balance Sheet-December 31, 20X1, with Consolidating Information," and the columns including the consolidating information might be marked, "Consolidating Information." When the consolidating information is presented in separate schedules, the schedules presenting balance sheet information of the components might be titled, for example, "Consolidating Schedule, Balance Sheet Information, December 31, 20X1."

[Source: Paragraph .18 of AU section 551A[*]]

[*] See footnote * in section title.

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.16 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 consolidated balance sheets of ABC 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 audit.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided 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 the ABC Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 20X2, and 20X1 (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[*Signature*]

[*Date*]

[Source: Paragraph .10 of AU section 552, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*)]

[*The next page is 9471.*]

AAM Section 9250

Engagements to Report on Internal Control

.01 Auditor's Report When Expressing an Unqualified Opinion Directly on an Entity's Internal Control Over Financial Reporting as of a Specified Date

Independent Auditor's Report

We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[1] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the examination of internal control*] expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

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[1] For example, the following may be used to identify the criteria: "criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."

[Source: Example 1 in paragraph .169 of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*)]

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.02 Auditor's Report When Expressing an Unqualified Opinion Directly on an Entity's Internal Control Over Financial Reporting as of a Specified Date—Insured Depository Institution That Is a Bank (Which Is Not Subject to Section 404 of the Sarbanes-Oxley Act of 2002) That Has Elected to Report on Controls for Purposes of Section 112 of the Federal Deposit Insurance Corporation Improvement Act at the Bank Holding Company Level

Independent Auditor's Report

We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[2] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with accounting principles generally accepted in the United States of America. Because management's assessment and our examination were conducted to meet the reporting requirements of Section 112 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), our examination of [*Holding Company's*] internal control over financial reporting included controls over the preparation of financial statements in accordance with accounting principles generally accepted in the United States of America and with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C).[3] An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

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[2] See footnote 1.

[3] This sentence would be modified if the insured depository institution (IDI) reports at the institution level rather than at the bank holding company level to refer to the Federal Financial Institutions Examination Council Instructions for Consolidated Reports of Condition and Income or the Office of Thrift Supervision Instructions for Thrift Financial Reports instead of to the Form FR Y-9C. This sentence would also be modified if the IDI reports at a holding company level and employs another approach to reporting on controls over the preparation of regulatory reports as permitted by FIL 86-94.

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the examination of internal control*] expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

[Source: Derived from example 1 in paragraph .169 and paragraph .171 of AT section 501]

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.03 Auditor's Report When Expressing an Unqualified Opinion on a Written Assertion About an Entity's Internal Control Over Financial Reporting as of a Specified Date

Independent Auditor's Report

We have examined management's assertion, included in the accompanying [*title of management report*], that W Company maintained effective internal control over financial reporting as of December 31, 20XX based on [*identify criteria*].[4] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on management's assertion based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that W Company maintained effective internal control over financial reporting as of December 31, 20XX is fairly stated, in all material respects, based on [*identify criteria*].

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the examination of internal control*] expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

[Source: Example 2 in paragraph .169 of AT section 501]

[4] See footnote 1.

.04 Adverse Opinion on Internal Control When a Material Weakness in Internal Control Exists as of a Specified Date

Independent Auditor's Report

We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[5] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. The following material weakness has been identified and included in the accompanying [*title of management's report*].

In our opinion, because of the effect of the material weakness described above on the achievement of the objectives of the control criteria, W Company has not maintained effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company. We considered the material weakness identified above in determining the nature, timing, and extent of audit tests applied in our audit of the 20XX financial statements, and this report does not affect our report dated [*date of report, which should be the same as the date of the report on the examination of internal control*], which expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

[Source: Example 3 in paragraph .169 of AT section 501]

[5] See footnote 1.

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.05 Disclaimer of Opinion When Restrictions That Significantly Limit the Scope of the Examination Are Imposed by the Client or the Responsible Party

Independent Auditor's Report

We were engaged to examine W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[6] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*].

Accordingly, we were unable to perform auditing procedures necessary to form an opinion on W Company's internal control over financial reporting as of December 31, 20XX.

Because of the limitation on the scope of our audit described in the paragraph above, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness of W Company's internal control over financial reporting.

[*Signature*]

[*Date*]

[Source: Paragraph .118 and example 4 in paragraph .169 of AT section 501]

[6] See footnote 1.

.06 Disclaimer of Opinion When Restrictions That Significantly Limit the Scope of the Examination Are Imposed by the Client or the Responsible Party and the Limited Procedures Performed by the Auditor Caused the Auditor to Conclude That One or More Material Weaknesses Exist

Independent Auditor's Report

We were engaged to examine W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[7] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*].

Accordingly, we were unable to perform auditing procedures necessary to form an opinion on W Company's internal control over financial reporting as of December 31, 20XX.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. If one or more material weaknesses exist, an entity's internal control over financial reporting cannot be considered effective. The following material weakness has been identified and included in the accompanying [*title of management's report*].

Because of the limitation on the scope of our audit described in the second paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the effectiveness W Company's internal control over financial reporting.

We have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report*] expressed [*include nature of opinion*]. We considered the material weakness identified above in determining the nature, timing, and extent of audit tests applied in our audit of the 20XX financial statements, and this report does not affect such report on the financial statements.

[*Signature*]

[*Date*]

[Source: Paragraphs .118–.119 and example 4 in paragraph .169 of AT section 501]

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[7] See footnote 1.

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.07 Unqualified Opinion on Internal Control When the Auditor Decides to Make Reference to the Report of Another Practitioner as the Basis, in Part, for the Auditor's Opinion on the Entity's Internal Control

Independent Auditor's Report

We have examined W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[8] W Company's management is responsible for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on W Company's internal control over financial reporting based on our examination. We did not examine the effectiveness of internal control over financial reporting of B Company, a wholly owned subsidiary, whose financial statements reflect total assets and revenues constituting 20 percent and 30 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 20XX. The effectiveness of B Company's internal control over financial reporting was examined by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the effectiveness of B Company's internal control over financial reporting, is based solely on the report of the other auditors.

We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the examination to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our examination included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our examination also included performing such other procedures as we considered necessary in the circumstances. We believe that our examination and the report of the other auditors provide a reasonable basis for our opinion.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls 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 auditors, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[9]

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[8] See footnote 1.

[9] Whether the other auditor's opinion is expressed on management's assertion or on internal control does not affect the determination of whether the principal auditor's opinion is expressed on management's assertion or on internal control. Paragraph .125 of AT section 501, *An Examination of an Entity's Internal Control Over Financial Reporting That Is Integrated With an Audit of Its Financial Statements* (AICPA, *Professional Standards*), establishes standards and provides guidance when the principal auditor decides to make reference to the report of the other auditor as a basis, in part, for his or her opinion on the entity's internal control.

We also have audited, in accordance with auditing standards generally accepted in the United States of America, the [*identify financial statements*] of W Company and our report dated [*date of report, which should be the same as the date of the report on the examination of internal control*] expressed [*include nature of opinion*].

[*Signature*]

[*Date*]

[Source: Example 5 in paragraph .169 of AT section 501]

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.08 Auditor's Combined Report When Expressing an Unqualified Opinion on an Entity's Internal Control and on the Financial Statements as of a Specified Date[10]

Independent Auditor's Report

We have audited the accompanying balance sheet of W Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. We also have audited W Company's internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].[11] W. Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assertion of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on these financial statements and an opinion on W Company's internal control over financial reporting based on our audits.

We conducted our audit of the financial statements in accordance with auditing standards generally accepted in the United States of America and our audit of internal control over financial reporting in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audit of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

An entity's internal control over financial reporting is a process effected by those charged with governance, management, and other personnel, designed to provide reasonable assurance regarding the preparation of reliable financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*]. An entity's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the entity; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with [*applicable financial reporting framework, such as accounting principles generally accepted in the United States of America*], and that receipts and expenditures of the entity are being made only in accordance with authorizations of management and those charged with governance; and (3) provide reasonable assurance regarding prevention, or timely detection and correction of unauthorized acquisition, use, or disposition of the entity's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent, or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[10] Because the examination of internal control is integrated with the audit of the financial statements and an examination provides the same level of assurance as an audit, the auditor may refer to the examination of internal control as an audit in his or her report or other communications.

[11] See footnote 1.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20XX, based on [*identify criteria*].

[*Signature*]

[*Date*]

[Source: Example 6 in paragraph .169 of AT section 501]

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.09 Communication of Significant Deficiencies and Material Weaknesses

In connection with our audit of W Company's (the "Company") financial statements as of December 31, 20XX and for the year then ended, and our audit of the Company's internal control over financial reporting as of December 31, 20XX ("integrated audit"), the standards established by the American Institute of Certified Public Accountants require that we advise you of the following internal control matters identified during our integrated audit.

Our responsibility is to plan and perform our integrated audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects (that is, whether material weaknesses exist as of the date specified in management's assertion). The integrated audit is not designed to detect deficiencies that, individually or in combination, are less severe than a material weakness. However, we are responsible for communicating to management and those charged with governance significant deficiencies and material weaknesses identified during the integrated audit. We are also responsible for communicating to management deficiencies that are of a lesser magnitude than a significant deficiency, unless previously communicated, and inform those charged with governance when such a communication was made.

A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. [*A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the Company's financial statements will not be prevented, or detected and corrected on a timely basis. We believe the following deficiencies constitute material weaknesses:*]

[*Describe the material weaknesses that were identified during the integrated audit. The auditor may separately identify those material weaknesses that exist as of the date of management's assertion by referring to the auditor's report.*]

[*A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. We consider the following deficiencies to be significant deficiencies:*]

[*Describe the significant deficiencies that were identified during the integrated audit.*]

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .170 of AT section 501]

.10 Assertion by Management on Controls at a Service Organization Relevant to the Security, Availability, Processing Integrity, and Confidentiality Principles

Management of XYZ Service Organization's Assertion Regarding Its Accurate Claims Processing System for the Period January 1, 20X1, to December 31, 20X1

We have prepared the attached description titled "Description of XYZ Service Organization's Accurate Claims Processing System for the Period January 1, 20X1, to December 31, 20X1" (the description), based on the criteria in items (a)(i)–(ii) below, which are the criteria for a description of a service organization's system in paragraphs 1.33–.34 of the AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy* (the description criteria). The description is intended to provide users with information about the Accurate Claims Processing System, particularly system controls intended to meet the criteria for the security, availability, processing integrity, and confidentiality principles set forth in TSP section 100, *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy* (AICPA, *Technical Practice Aids*) (applicable trust services criteria). We confirm, to the best of our knowledge and belief, that

a. the description fairly presents the [*type or name of*] system throughout the period [*date*] to [*date*], based on the following description criteria:

i. The description contains the following information:

(1) The types of services provided

(2) The components of the system used to provide the services, which are the following:

- *Infrastructure*. The physical and hardware components of a system (facilities, equipment, and networks).
- *Software*. The programs and operating software of a system (systems, applications, and utilities).
- *People*. The personnel involved in the operation and use of a system (developers, operators, users, and managers).
- *Procedures*. The automated and manual procedures involved in the operation of a system.
- *Data*. The information used and supported by a system (transaction streams, files, databases, and tables).

(3) The boundaries or aspects of the system covered by the description

(4) How the system captures and addresses significant events and conditions

(5) The process used to prepare and deliver reports and other information to user entities and other parties

(6) If information is provided to, or received from, subservice organizations or other parties, how such information is provided or received; the role of the subservice organization and other parties; and the procedures performed to determine that such information and its processing, maintenance, and storage are subject to appropriate controls

(7) For each principle being reported on, the applicable trust services criteria and the related controls designed to meet those criteria, including, as applicable, complementary user-entity controls contemplated in the design of the service organization's system

(8) For subservice organizations presented using the carve-out method, the nature of the services provided by the subservice organization; each of the applicable trust services criteria that are intended to be met by controls at the subservice organization, alone or in combination with controls at the service organization, and the types of controls expected to be implemented at carved-out subservice organizations to meet those criteria; and for

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privacy, the types of activities that the subservice organization would need to perform to comply with our privacy commitments

(9) Any applicable trust services criteria that are not addressed by a control at the service organization or a subservice organization and the reasons therefore

(10) Other aspects of the service organization's control environment, risk assessment process, information and communication systems, and monitoring of controls that are relevant to the services provided and the applicable trust services criteria

(11) Relevant details of changes to the service organization's system during the period covered by the description

ii. The description does not omit or distort information relevant to the service organization's system while acknowledging that the description is prepared to meet the common needs of a broad range of users and may not, therefore, include every aspect of the system that each individual user may consider important to his or her own particular needs.

b. the controls stated in description were suitably designed throughout the specified period to meet the applicable trust services criteria.

c. the controls stated in the description operated effectively throughout the specified period to meet the applicable trust services criteria.

[Source: AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*, updated as of May 1, 2011, example 1 in appendix C]

.11 Report on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, and Confidentiality

> ***Note:*** Language shown in boldface italics represents modifications that would be made to the service auditor's report if complementary user-entity controls are needed to meet certain applicable trust services criteria.

Independent Service Auditor's Report

To: XYZ Service Organization

Scope

We have examined the attached description titled "Description of XYZ Service Organization's Accurate Claims Processing System for the Period January 1, 20X1, to December 31, 20X1"[12] (the description) and the suitability of the design and operating effectiveness of controls to meet the criteria for the security, availability, processing integrity, and confidentiality principles set forth in TSP section 100, *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy* (AICPA, *Technical Practice Aids*) (applicable trust services criteria), throughout the period January 1, 20X1, to December 31, 20X1. ***The description indicates that certain applicable trust services criteria specified in the description can be achieved only if complementary user-entity controls contemplated in the design of XYZ Service Organization's controls are suitably designed and operating effectively, along with related controls at the service organization. We have not evaluated the suitability of the design or operating effectiveness of such complementary user-entity controls.***

Service organization's responsibilities

XYZ Service Organization has provided the attached assertion titled "Management of XYZ Service Organization's Assertion Regarding Its Accurate Claims Processing System for the Period January 1, 20X1, to December 31, 20X1,"[13] which is based on the criteria identified in management's assertion. XYZ Service Organization is responsible for (1) preparing the description and assertion; (2) the completeness, accuracy, and method of presentation of both the description and assertion; (3) providing the services covered by the description; (4) specifying the controls that meet the applicable trust services criteria and stating them in the description; and (5) designing, implementing, and documenting the controls to meet the applicable trust services criteria.

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description based on the description criteria set forth in XYZ Service Organization's assertion and on the suitability of the design and operating effectiveness of the controls to meet the applicable trust services criteria, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, (1) the description is fairly presented based on the description criteria, and (2) the controls were suitably designed and operating effectively to meet the applicable trust services criteria throughout the period January 1, 20X1, to December 31, 20X1.

Our examination involved performing procedures to obtain evidence about the fairness of the presentation of the description based on the description criteria and the suitability of the design and operating effectiveness of those controls to meet the applicable trust services criteria. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to meet the applicable trust services criteria. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the applicable trust services

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[12] The title of the description of the service organization's system in the service auditor's report should be the same as the title used by management of the service organization in its description of the service organization's system.

[13] The title of the assertion in the service auditor's report should be the same as the title used by management of the service organization in its assertion.

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criteria were met. Our examination also included evaluating the overall presentation of the description. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

Because of their nature and inherent limitations, controls at a service organization may not always operate effectively to meet the applicable trust services criteria. Also, the projection to the future of any evaluation of the fairness of the presentation of the description or conclusions about the suitability of the design or operating effectiveness of the controls to meet the applicable trust services criteria is subject to the risks that the system may change or that controls at a service organization may become inadequate or fail.

Opinion

In our opinion, in all material respects, based on the description criteria identified in XYZ Service Organization's assertion and the applicable trust services criteria

a. the description fairly presents the system that was designed and implemented throughout the period January 1, 20X1, to December 31, 20X1.

b. the controls stated in the description were suitably designed to provide reasonable assurance that the applicable trust services criteria would be met if the controls operated effectively throughout the period January 1, 20X1 to December 31, 20X1, ***and user entities applied the complementary user-entity controls contemplated in the design of XYZ Service Organization's controlsthroughout the period January 1, 20X1, to December 31, 20X1***.

c. the controls tested, which ***together with the complementary user-entity controls referred to in the scope paragraph of this report, if operating effectively,*** were those necessary to provide reasonable assurance that the applicable trust services criteria were met, operated effectively throughout the period January 1, 20X1, to December 31, 20X1.

Description of tests of controls

The specific controls we tested and the nature, timing, and results of our tests are presented in the section of our report titled "Description of Test of Controls and Results Thereof."

Intended use

This report and the description of tests of controls and results thereof are intended solely for the information and use of XYZ Service Organization; user entities of XYZ Service Organization's Accurate Claims Processing System during some or all of the period January 1, 20X1, to December 31, 20X1; and prospective user entities, independent auditors and practitioners providing services to such user entities, and regulators who have sufficient knowledge and understanding of the following:

- The nature of the service provided by the service organization
- How the service organization's system interacts with user entities, subservice organizations, and other parties
- Internal control and its limitations
- Complementary user-entity controls and how they interact with related controls at the service organization to meet the applicable trust services criteria
- The applicable trust services criteria
- The risks that may threaten the achievement of the applicable trust services criteria and how controls address those risks

This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*, updated as of May 1, 2011, example 1 in appendix C]

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.12 Assertion by Management Regarding a Description of a Service Organization's System, the Suitability of the Design and Operating Effectiveness of Its Controls Relevant to the Privacy Principle, and Its Compliance With Commitments in Its Statement of Privacy Practices

Management of XYZ Service Organization's Assertion

We have prepared the attached description titled [*title of the description*][14] (the description) of XYZ Service Organization's [*type or name of*] system and our statement of privacy practices[15] related to XYZ Service Organization's [*type or name of*] service. The description is intended to provide users with information about our system, particularly system controls intended to meet the criteria for the privacy principle set forth in TSP section 100, *Trust Services Principles, Criteria, and Illustrationsfor Security, Availability, Processing Integrity, Confidentiality, and Privacy* (AICPA, *Technical Practice Aids*)[16] (applicable trust services criteria). We confirm, to the best of our knowledge and belief, that

- the description fairly presents the [*type or name of*] system throughout the period [*date*] to [*date*]. The criteria for the description are identified below under the heading "Description Criteria."
- the controls stated in the description were suitably designed and operated effectively throughout the period [*date*] to [*date*] to meet the criteria for the privacy principle set forth in TSP section 100 (the applicable trust services criteria).
- we complied with the commitments in our statement of privacy practices, in all material respects, throughout the period [*date*] to [*date*].

Description Criteria

In preparing our description and making our assertion regarding the fairness of the presentation of the description, we used the criteria in items (a)–(b) below, which are the criteria in paragraphs 1.33–.34 of the AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy*:

a. The description contains the following information:

  i. The types of services provided.

  ii. The components of the system used to provide the services, which are the following:

   (1) *Infrastructure*. The physical and hardware components of a system (facilities, equipment, and networks).

   (2) *Software*. The programs and operating software of a system (systems, applications, and utilities).

   (3) *People*. The personnel involved in the operation and use of a system (developers, operators, users, and managers).

   (4) *Procedures*. The automated and manual procedures involved in the operation of a system.

   (5) *Data*. The information used and supported by a system (transaction streams, files, databases, and tables).

  iii. The boundaries or aspects of the system covered by the description and the service auditor's report. As it relates to the privacy of information, a system includes, at a minimum, all system

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[14] Insert the title of the description of the service organization's system used by management of the service organization in its description (for example, "Description of XYZ Service Organization's Claims-Processing System Throughout the Period January 1, 20X1, to December 31, 20X1, Including its Statement of Privacy Practices").

[15] In many cases, the user entities provide a privacy notice to the individuals about whom information is collected. In such cases, the service organization would prepare a statement of privacy practices for use by the user entities to describe its practices and commitments to user entities related to the matters typically included in a privacy notice to individuals. If the service organization is responsible for providing the privacy notice directly to individuals, such notice may be a suitable substitute for a statement of privacy practices.

[16] The criteria for privacy are also set forth in *Generally Accepted Privacy Principles* issued by the AICPA and the Canadian Institute of Chartered Accountants, which could be referenced here instead of TSP section 100, *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy* (AICPA, *Technical Practice Aids*).

components directly or indirectly related to the collection, use, retention, disclosure, and disposal or anonymization of personal information throughout its personal information life cycle.

iv. The types of personal information collected from individuals or obtained from user entities or other parties and how such information is collected and, if collected by user entities, how it is obtained by the service organization.

v. The process for (1) identifying specific requirements in agreements with user entities and laws and regulations applicable to personal information and (2) implementing controls and practices to meet those requirements.

vi. If the service organization provides the privacy notice to individuals about whom personal information is collected, used, retained, disclosed, and disposed of or anonymized, the privacy notice prepared in conformity with the relevant criteria for a privacy notice set forth in TSP section 100.

vii. If the user entities, rather than the service organization, are responsible for providing the privacy notice to individuals, a statement regarding how the privacy notice is communicated to individuals, that the user entities are responsible for communicating such notice to the individuals, and that the service organization is responsible for communicating its privacy practices to the user entities in its statement of privacy practices, which includes the following information:

(1) A summary of the significant privacy and related security requirements common to most agreements between the service organization and its user entities and any requirements in a user-entity agreement that the service organization meets for all or most user entities

(2) A summary of the significant privacy and related security requirements mandated by law, regulation, an industry, or a market that the service organization meets for all or most user entities that are not included in user-entity agreements

(3) The purposes, uses, and disclosures of personal information as permitted by user-entity agreements and beyond those permitted by such agreements but not prohibited by such agreements and the service organization's commitments regarding the purpose, use, and disclosure of personal information that are prohibited by such agreements

(4) A statement that the information will be retained for a period no longer than necessary to fulfill the stated purposes or contractual requirements or for the period required by law or regulation, as applicable, or a statement describing other retention practices

(5) A statement that the information will be disposed of in a manner that prevents loss, theft, misuse, or unauthorized access to the information

(6) If applicable, how the service organization supports any process permitted by user entities for individuals to obtain access to their information to review, update, or correct it

(7) If applicable, a description of the process to determine that personal information is accurate and complete and how the service organization implements correction processes permitted by user entities

(8) If applicable, how inquiries, complaints, and disputes from individuals (whether directly from the individual or indirectly through user entities) regarding their personal information are handled by the service organization

(9) A statement regarding the existence of a written security program and what industry or other standards it is based on

(10) Other relevant information related to privacy practices deemed appropriate for user entities by the service organization

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viii. If the user entities, rather than the service organization, are responsible for providing the privacy notice to individuals, the service organization's statement of privacy practices.

ix. How the system captures and addresses significant events and conditions.

x. The process used to deliver services, reports, and other information to user entities and other parties.

xi. If information is provided to, or received from, subservice organizations or third parties

(1) how such information is provided or received and the role of the subservice organizations or other parties.

(2) the procedures performed to determine that such information is protected in conformity with the service organization's statement of privacy practices.

xii. For each principle being reported on, the applicable trust services criteria and the related controls designed to meet those criteria, including, as applicable, complementary user-entity controls contemplated in the design of the service organization's system.

xiii. For subservice organizations presented using the carve-out method

(1) the nature of the services provided by the subservice organization.

(2) if the description addresses the privacy principle, any aspects of the personal information life cycle for which responsibility has been delegated to the subservice organization, if applicable.

(3) each of the applicable trust services criteria that are intended to be met by controls at the subservice organization, alone or in combination with controls at the service organization, and the types of controls expected to be implemented at carved-out subservice organizations to meet those criteria.

(4) if the description addresses the privacy principle, the types of activities that the subservice organization would need to perform to comply with the service organization's privacy commitments.

xiv. Any applicable trust services criteria that are not addressed by a control at the service organization or subservice organization and the reasons therefore.

xv. Other aspects of the service organization's control environment, risk assessment process, information and communication systems, and monitoring of controls that are relevant to the services provided, the personal information life cycle, and the applicable trust services criteria.

xvi. Relevant details of changes to the service organization's system during the period covered by the description.

b. The description does not omit or distort information relevant to the service organization's system and personal information life cycle while acknowledging that the description is presented to meet the common needs of a broad range of users and may not, therefore, include every aspect of the system and personal information life cycle that each individual user may consider important to his or her own particular needs.

[Source: AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*, updated as of May 1, 2011, example 2 in appendix C]

.13 Report on a Description of a Service Organization's System, the Suitability of the Design and Operating Effectiveness of Its Controls Relevant to the Privacy Principle, and Its Compliance With Commitments in Its Statement of Privacy Practices

Independent Service Auditor's Report

To: XYZ Service Organization

Scope

We have examined (1) the accompanying description titled [*title of the description*];[17] (2) the suitability of the design and operating effectiveness of controls to meet the criteria for the privacy principle set forth in TSP section 100, *Trust Services Principles, Criteria, and Illustrations for Security, Availability, Processing Integrity, Confidentiality, and Privacy* (AICPA, *Technical Practice Aids*) (applicable trust services criteria); and (3) XYZ Service Organization's compliance with the commitments in its statement of privacy practices throughout the period January 1, 20X1, to December 31, 20X1.

Service organization's responsibilities

XYZ Service Organization has provided the accompanying assertion titled [*title of assertion*].[18] XYZ Service Organization is responsible for (1) preparing the description and assertion; (2) the completeness, accuracy, and method of presentation of both the description and assertion; (3) providing the services covered by the description; (4) specifying the controls that meet the applicable trust services criteria and stating them in the description; (5) designing, implementing, maintaining, and documenting controls to meet the applicable trust services criteria; and (6) complying with the commitments in its statement of privacy practices that is included in the description.

Service auditor's responsibilities

Our responsibility is to express an opinion on (1) the fairness of the presentation of the description based on the description criteria identified in management's assertion; (2) the suitability of the design and operating effectiveness of the controls to meet the applicable trust services criteria; and (3) XYZ Service Organization's compliance with the commitments in its statement of privacy practices, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, (1) the description is fairly presented based on the description criteria, (2) the controls were suitably designed and operating effectively to meet the applicable trust services criteria throughout the period from [*date*] to [*date*], and (3) XYZ Service Organization complied with the commitments in its statement of privacy practices throughout the period from [*date*] to [*date*].

Our examination involved performing procedures to obtain evidence about the fairness of the presentation of the description based on the description criteria, the suitability of the design and operating effectiveness of the controls to meet the applicable trust services criteria, and XYZ Service Organization's compliance with the commitments in its statement of privacy practices. Our procedures included assessing the risks that the description is not fairly presented, that the controls were not suitably designed or operating effectively to meet the applicable trust services criteria, and that XYZ Service Organization did not comply with the commitments in its statement of privacy practices. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the applicable trust services criteria were met and testing XYZ Service Organization's compliance with the commitments in its statement of privacy practices. Our examination also included evaluating the overall presentation of the description. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

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[17] Insert the title of the description used by management of the service organization (for example, "Description of XYZ Service Organization's Claims Processing System Throughout the Period January 1, 20X1, to December 31, 20X1, Including Its Statement of Privacy Practices").

[18] Insert the title of the assertion used by management of the service organization (for example, "Management of XYZ Service Organization's Assertion Regarding Its Description of the Claims-Processing System, the Suitability of the Design and Operating Effectiveness of Controls, and Compliance With the Commitments in Its Statement of Privacy Practices Throughout the Period January 1, 20X1, to December 31, 20X1").

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Inherent limitations

Because of their nature and inherent limitations, controls at a service organization may not always protect personal information against unauthorized access or use nor do they ensure compliance with applicable laws and regulations. For example, fraud or unauthorized access to personal information or unauthorized use or disclosure of personal information by persons authorized to access it may not be prevented or detected, or service organization personnel may not always comply with the commitments in the statement of privacy practices. Also, the projection of any conclusions, based on our findings, to future periods is subject to the risk that any changes or future events may alter the validity of such conclusions.

Opinion

In our opinion, in all material respects, based on the description criteria identified in XYZ Service Organization's assertion and the applicable trust services criteria

a. the description fairly presents XYZ Service Organization's [*type or name of*] system and related privacy practices that were designed and implemented throughout the period [*date*] to [*date*].

b. the controls stated in the description were suitably designed to provide reasonable assurance that the applicable trust services criteria would be met if the controls operated effectively throughout the period [*date*] to [*date*].

c. the controls we tested, which were those necessary to provide reasonable assurance that the applicable trust services criteria were met, operated effectively throughout the period [*date*] to [*date*].

d. XYZ Service Organization complied with the commitments in its statement of privacy practices throughout the period [*date*] to [*date*].

Description of tests of controls

The specific controls and privacy commitments tested and the nature, timing, and results of those tests are listed on pages [*yy–zz*].

Intended use

This report and the description of tests of controls, tests of privacy commitments, and results thereof in section X of this report are intended solely for the information and use of XYZ Service Organization; user entities of XYZ Service Organization's [type or name of] system during some or all of the period [date] to [date]; and those prospective user entities, independent auditors and practitioners providing services to such user entities, and regulators who have sufficient knowledge and understanding of the following:

- The nature of the service provided by the service organization
- How the service organization's system interacts with user entities, subservice organizations, and other parties
- Internal control and its limitations
- Complementary user-entity controls and how they interact with related controls at the service organization to meet the applicable trust services criteria
- The applicable trust services criteria
- The risks that may threaten the achievement of the applicable trust services criteria and how controls address those risks

This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: AICPA Guide *Reporting on Controls at a Service Organization Relevant to Security, Availability, Processing Integrity, Confidentiality, or Privacy (SOC 2)*, updated as of May 1, 2011, example 2 in appendix C]

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.14 Unqualified Opinion About the Suitability of Design of the Entity's Internal Control

Independent Accountant's Report

Addressee:

We have examined the suitability of the design of W Company's internal control over financial reporting to prevent or detect and correct material misstatements in its financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for the suitable design of internal control over financial reporting. Our responsibility is to express an opinion on the design of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, evaluating the design of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. We were not engaged to examine and report on the operating effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, and, accordingly, we express no opinion on operating effectiveness.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, W Company's internal control over financial reporting was suitably designed, in all material respects, to prevent or detect and correct material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*].

[*Signature*]

[*Date*]

[Source: Interpretation No. 7, "Reporting on the Design of Internal Control," of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, AT sec. 9101 par. .59–.69)]

> ***Note:*** This report assumes that the control criteria of the regulatory agency are both suitable and available to users as discussed in paragraphs .23–.34 of AT section 101. Therefore, there is no restriction on the use of this report.

.15 Unqualified Opinion About the Suitability of Design of the Entity's Internal Control That Has Not Yet Been Implemented

Independent Accountant's Report

Addressee:

We have examined the suitability of the design of W Company's internal control over financial reporting to prevent or detect and correct material misstatements in its financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*]. W Company's management is responsible for the suitable design of internal control over financial reporting. Our responsibility is to express an opinion on the design of internal control based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, evaluating the design of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Because operations had not begun as of December 31, 20XX, we could not confirm that the specified controls were implemented. Accordingly, our report solely addresses the suitability of the design of the W Company's internal control and does not address whether the controls were implemented. Furthermore, because the specified controls have not yet been implemented, we were unable to test, and did not test, the operating effectiveness of W Company's internal control over financial reporting as of December 31, 20XX, and, accordingly, we express no opinion on operating effectiveness.

Because of its inherent, internal control, over financial reporting may not prevent or detect and correct misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may not be implemented as intended when operations begin or may become inadequate because of changes in conditions.

In our opinion, W Company's internal control over financial reporting was suitably designed, in all material respects, to prevent or detect and correct material misstatements in the financial statements on a timely basis as of December 31, 20XX, based on [*identify criteria*].

[*Signature*]

[*Date*]

[Source: Interpretation No. 7 of AT section 101]

Note: This report assumes that the control criteria of the regulatory agency are both suitable and available to users as discussed in paragraphs .23–.34 of AT section 101. Therefore, there is no restriction on the use of this report.

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.16 Communicating Internal Control Related Matters Identified in an Audit

Addressee:

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Our consideration of internal control was for the limited purpose described in the preceding paragraph and was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses and therefore, there can be no assurance that all deficiencies, significant deficiencies, or material weaknesses have been identified. However, as discussed below, we identified certain deficiencies in internal control that we consider to be material weaknesses [*and other deficiencies that we consider to be significant deficiencies*].

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or a combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis. [*We consider the following deficiencies in the Company's internal control to be material weaknesses:*]

[*Describe the material weaknesses that were identified*.]

[*A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.We consider the following deficiencies in the Company's internal control to be significant deficiencies:*]

[*Describe the significant deficiencies that were identified*.]

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

[Source: Paragraphs .25 and .28 of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*)[19]]

[19] See section 8300, "Communicating Internal Control Related Matters in an Audit—Understanding SAS No. 115," for further guidance.

.17 Communicating Internal Control Related Matters Identified in an Audit When the Auditor Has Not Identified Any Material Weaknesses and Wishes to Communicate That to Management and Those Charged With Governance

Addressee:

In planning and performing our audit of the financial statements of ABC Company (the "Company") as of and for the year ended December 31, 20XX, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

A deficiency in internal control exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct misstatements on a timely basis. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first paragraph and was not designed to identify all deficiencies in internal control that might be deficiencies, significant deficiencies, or material weaknesses. We did not identify any deficiencies in internal control that we consider to be material weaknesses, as defined above.

This communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the organization, and [*identify any specified governmental authorities*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.

[Source: Paragraphs .25–.28 of AU section 325[20]]

> ***Note:*** If one or more significant deficiencies have been identified, the auditor may add the following sentence to the third paragraph of the communication:
>
> However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [*date*]. A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

[20] See footnote 19.

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.18 Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Participants in Office of Management and Budget Single Audit Pilot Project

Addressee:

This communication is provided pursuant to the parameters of the 2009 Office of Management and Budget (OMB) pilot project. Such project requires auditors of entities that volunteer for the project to issue, in writing, an early communication of significant deficiencies and material weaknesses in internal control over compliance for certain federal programs having expenditures of American Recovery and Reinvestment Act of 2009 (ARRA) funding at an interim date, prior to the completion of the compliance audit. Accordingly, this communication is based on our audit procedures performed through [insert "as of date"], an interim period. Because we have not completed our compliance audit, additional significant deficiencies and material weaknesses may be identified and communicated in our final report on compliance and internal control over compliance issued to meet the reporting requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations.*

In planning and performing our audit through [*insert "as of date"*] of [*identify the federal programs selected to be tested as a major program from the federal list of approved ARRA pilot project programs*], we are considering [*Example Entity's*] compliance with [*list the applicable types of compliance requirements subject to the communication requirement in the pilot project (for example, activities allowed or unallowed, allowable costs and cost principles, cash management, eligibility, reporting, and special tests and provisions)*] as described in the *OMB Circular A-133 Compliance Supplement* for the year ended June 30, 2009. We are also considering [*Example Entity's*] internal control over compliance with the requirements previously described that could have a direct and material effect on [*identify the federal programs selected to be tested as a major program from the federal list of approved ARRA pilot project programs*] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the [*Example Entity's*] internal control over compliance.

Our consideration of internal control over compliance is for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined in the following paragraph. However, as discussed subsequently, based on the audit procedures performed through [*insert "as of date"*], we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and other deficiencies that we consider to be material weaknesses.

A *deficiency in internal control* over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement[21] of a federal program on a timely basis. A *material weakness* in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. We consider the following deficiencies in internal control over compliance to be material weaknesses:

[21] Under Section 510(a)(1) of Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, the auditor's determination of whether a deficiency in internal control over compliance is a material weakness or significant deficiency for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or an audit objective identified in the *OMB Circular A-133 Compliance Supplement* (the *Compliance Supplement*). This reference to "type of compliance requirement" refers to the 14 types of compliance requirements (identified as A-N) described in part 3 of the *Compliance Supplement*. For purposes of reporting audit findings, auditors are alerted that certain of the types of compliance requirements may include multiple compliance requirements with multiple audit objectives (for example, compliance requirement "G" covers 3 separate requirements—matching, level of effort, and earmarking; and "N" covers separate requirements specific to each individual special test and provision).

[*Describe the material weaknesses that were identified either here or by reference to a separate schedule.*][22]

A *significant deficiency* in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in internal control over compliance to be significant deficiencies:

[Describe the significant deficiencies that were identified either here or by reference to a separate schedule.][23]

[*Example Entity's*] responses to our findings are described [*insert either "in the preceding paragraph" or "in the accompanying schedule"*]. We did not audit [*Example Entity's*] responses and, accordingly, we express no opinion on the responses.[24]

This interim communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], federal awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.[25]

[Source: Paragraph .25 of AU section 325 and paragraph .06 of Interpretation No. 2, "Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Participants in Office of Management and Budget Single Audit Pilot Project," of AU section 325 (AICPA, *Professional Standards*, AU sec. 9325 par. .04–.06)]

[22] The OMB pilot project requires the auditee, upon receipt of the interim communication from the auditor, to provide it to the federal cognizant agency for audit. Federal agencies are required to follow-up with the auditee concerning actions taken or needed to correct the finding. Therefore, to assist the federal agencies with this responsibility, significant deficiency and material weakness finding descriptions should include the level of detail required by both *Government Auditing Standards* and Section 510(b) of OMB Circular A-133. This would require the inclusion of, among other things, the views of responsible officials (see footnote 24).

[23] See footnote 22.

[24] The OMB pilot project requires the auditor to obtain management responses to the internal control matters identified and to include them in the interim communication.

[25] According to paragraph .13 of Interpretation No. 4, "Appropriateness of Identifying No Significant Deficiencies or No Material Weaknesses in an Interim Communication," of AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, AU sec. 9325 par. .11–.13), although AU section 325 would permit the auditor to issue a communication at the end of an audit stating that no material weaknesses were identified by the auditor, it would not be appropriate for an auditor to do so at an interim date. Making such a communication at an interim date could lead to misinterpretation by management and those charged with governance, that there are no identified material weaknesses when, in fact, material weaknesses could be identified before completion of the compliance audit.

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.19 Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Auditors That Are Not Participants in Office of Management and Budget Pilot Project

Addressee:

This communication is provided pursuant to the *Office of Management and Budget (OMB) Circular A-133 Compliance Supplement*, which encourages auditors to communicate, at an interim date, control deficiencies related to federal programs with expenditures of American Recovery and Reinvestment Act of 2009 (ARRA) funding that are, or likely to be, significant deficiencies or material weaknesses in internal control over compliance. Accordingly, this communication is based on our audit procedures performed through [*insert "as of date"*], an interim period. Because we have not completed our compliance audit, additional significant deficiencies and material weaknesses may be identified and communicated in our final report on compliance and internal control over compliance issued to meet the reporting requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*.

In planning and performing our audit through [*insert "as of date"*] of [*identify the federal programs with ARRA expenditures selected by the auditor to be tested as a major program*], we are considering [*Example Entity's*] compliance with the applicable types of compliance requirements as described in the *OMB Circular A-133 Compliance Supplement* for the year ended June 30, 20XX. We are also considering [*Example Entity's*] internal control over compliance with the requirements previously described that could have a direct and material effect on [identify the federal programs with ARRA expenditures selected by the auditor to be tested as a major program] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on internal control over compliance in accordance with OMB Circular A-133, but not for the purpose of expressing an opinion on the effectiveness of internal control over compliance. Accordingly, we do not express an opinion on the effectiveness of the [*Example Entity's*] internal control over compliance.

Our consideration of internal control over compliance is for the limited purpose described in the preceding paragraph and would not necessarily identify all deficiencies in the entity's internal control that might be significant deficiencies or material weaknesses as defined in the following paragraph. However, as discussed subsequently, based on the audit procedures performed through [*insert "as of date"*], we identified certain deficiencies in internal control over compliance that we consider to be significant deficiencies and other deficiencies that we consider to be material weaknesses.

A *deficiency in internal control* over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance with a type of compliance requirement[26] of a federal program on a timely basis. A *material weakness* in internal control over compliance is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a type of compliance requirement of a federal program will not be prevented, or detected and corrected, on a timely basis. We consider the following deficiencies in internal control over compliance to be material weaknesses:

[*Describe the material weaknesses that were identified either here or by reference to a separate schedule.*]

A *significant deficiency* in internal control over compliance is a deficiency, or a combination of deficiencies, in internal control over compliance with a type of compliance requirement of a federal program that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. We consider the following deficiencies in internal control over compliance to be significant deficiencies:

[*Describe the significant deficiencies that were identified either here or by reference to a separate schedule.*]

This interim communication is intended solely for the information and use of management, [*identify the body or individuals charged with governance*], others within the entity, [*identify the legislative or regulatory body*], federal

[26] See footnote 21.

awarding agencies, and pass-through entities and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

The auditor should not issue a written communication stating that no significant deficiencies were identified during the audit.[27]

[Source: Paragraph .25 of AU section 325 and paragraph .10 of Interpretation No. 3, "Communication of Significant Deficiencies and Material Weaknesses Prior to the Completion of the Compliance Audit for Auditors That Are Not Participants in Office of Management and Budget Pilot Project," of AU section 325 (AICPA, *Professional Standards*, AU sec. 9325 par. .07–.10)]

> The illustrative reports in paragraphs .20–.21 are based on AU section 324, *Service Organizations* (AICPA, *Professional Standards*)[*]

[27] See footnote 25.

[*] In April 2010, Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801), was issued. It addresses examination engagements undertaken by a service auditor to report on controls at organizations that provide services to user entities when those controls are likely to be relevant to user entities' internal control over financial reporting. SSAE No. 16 supersedes the current requirements and guidance for service auditors in AU section 324, *Service Organizations* (AICPA, *Professional Standards*), and is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation is permitted. Accordingly, these illustrative reports and the related guidance included herein is applicable only to periods ending on or before June 14, 2011, and for which a service auditor has chosen not to early implement SSAE No. 16.

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.20 Report on Controls Placed in Operation at a Service Organization (Type 1 Report)

To XYZ Service Organization:

We have examined the accompanying description of controls related to the ___application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily,[28] and (3) such controls had been placed in operation as of __. The control objectives were specified by __. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

We did not perform procedures to determine the operating effectiveness of controls for any period. Accordingly, we express no opinion on the operating effectiveness of any aspects of XYZ Service Organization's controls, individually or in the aggregate.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of ___. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

The description of controls at XYZ Service Organization is as of ___and any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers ___.

[Source: Paragraph .38 of AU section 324]

Notes: This report should have an attachment containing a description of the service organization's controls that may be relevant to a user organization's internal control.

This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

Paragraph .39 of AU section 324 provides an illustrative explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors.

Paragraph .40 of AU section 324 provides an illustrative explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that there are significant deficiencies in the design or operation of the service organization's controls.

[28] If the application of controls by user organizations is necessary to achieve the stated control objectives, the service auditor's report should be modified to include the phrase "and user organizations applied the controls contemplated in the design of XYZ Service Organization's controls" following the words "complied with satisfactorily" in the scope and opinion paragraphs.

.21 Report on Controls Placed in Operation at a Service Organization and Tests of Operating Effectiveness (Type 2 Report)

Independent Service Auditor's Report

To XYZ Service Organization:

We have examined the accompanying description of controls related to the ___application of XYZ Service Organization. Our examination included procedures to obtain reasonable assurance about whether (1) the accompanying description presents fairly, in all material respects, the aspects of XYZ Service Organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, (2) the controls included in the description were suitably designed to achieve the control objectives specified in the description, if those controls were complied with satisfactorily,[29] and (3) such controls had been placed in operation as of __. The control objectives were specified by __. Our examination was performed in accordance with standards established by the American Institute of Certified Public Accountants and included those procedures we considered necessary in the circumstances to obtain a reasonable basis for rendering our opinion.

In our opinion, the accompanying description of the aforementioned application presents fairly, in all material respects, the relevant aspects of XYZ Service Organization's controls that had been placed in operation as of ___. Also, in our opinion, the controls, as described, are suitably designed to provide reasonable assurance that the specified control objectives would be achieved if the described controls were complied with satisfactorily.

In addition to the procedures we considered necessary to render our opinion as expressed in the previous paragraph, we applied tests to specific controls, listed in Schedule X, to obtain evidence about their effectiveness in meeting the control objectives, described in Schedule X, during the period from __to __. The specific controls and the nature, timing, extent, and results of the tests are listed in Schedule X. This information has been provided to user organizations of XYZ Service Organization and to their auditors to be taken into consideration, along with information about the internal control at user organizations, when making assessments of control risk for user organizations. In our opinion the controls that were tested, as described in Schedule X, were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in Schedule X were achieved during the period from ___to ___. [*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.*][30]

The relative effectiveness and significance of specific controls at XYZ Service Organization and their effect on assessments of control risk at user organizations are dependent on their interaction with the controls and other factors present at individual user organizations. We have performed no procedures to evaluate the effectiveness of controls at individual user organizations.

The description of controls at XYZ Service Organization is as of ____, and information about tests of the operating effectiveness of specific controls covers the period from __to __. Any projection of such information to the future is subject to the risk that, because of change, the description may no longer portray the controls in existence. The potential effectiveness of specific controls at the Service Organization is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected. Furthermore, the projection of any conclusions, based on our findings, to future periods is subject to the risk that changes may alter the validity of such conclusions.

This report is intended solely for use by the management of XYZ Service Organization, its customers, and the independent auditors of its customers.

[Source: Paragraph .54 of AU section 324]

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[29] See footnote 28.

[30] This sentence should be added when all of the control objectives listed in the description of controls placed in operation are not covered by the tests of operating effectiveness. This sentence would be omitted when all of the control objectives listed in the description of controls placed in operation are included in the tests of operating effectiveness.

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Notes: This report should have two attachments: (*a*) a description of the service organization's controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements and (*b*) a description of controls for which tests of operating effectiveness were performed, the control objectives the controls were intended to achieve, the tests applied, and the results of these tests.

This report is illustrative only and should be modified as appropriate to suit the circumstances of individual engagements.

Paragraph .55 of AU section 324 provides an illustrative explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that the description is inaccurate or insufficiently complete for user auditors.

Paragraph .56 of AU section 324 provides an illustrative explanatory paragraph and modification to the opinion paragraph when the service auditor concludes that there are sufficient deficiencies in the design or operation of the service organization's controls.

The illustrative reports in paragraphs .22–.31 are based on Statement on Standards for Attestation Engagements (SSAE) No. 16, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*, AT sec. 801)[†]

[†] SSAE No. 16 supersedes the current requirements and guidance for service auditors in AU section 324, and is effective for service auditors' reports for periods ending on or after June 15, 2011. Early implementation of SSAE No. 16 is permitted. Accordingly, this illustrative report is required when the examination engagement is undertaken for periods ending on or after June 15, 2011, unless a service auditor has chosen to early implement SSAE No. 16.

.22 Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 2 Report)

Independent Service Auditor's Report

To: XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] throughout the period [*date*] to [*date*] (description) and the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for the assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.[31]

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description throughout the period [*date*] to [*date*].

An examination of a description of a service organization's system and the suitability of the design and operating effectiveness of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description and the suitability of the design and operating effectiveness of those controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the related control objectives stated in the description were achieved. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page *[aa]*. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. Also, the projection to the future of any evaluation of the fairness of the presentation of the description, or

[31] When the control objectives have been specified by an outside party, the following sentence is added at the end of the paragraph describing the service organization's responsibilities:

> The control objectives have been specified by [*name of party specifying the control objectives*] and are stated on page [*aa*] of the description.

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conclusions about the suitability of the design or operating effectiveness of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become inadequate or fail.

Opinion

In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion on page [*aa*],

a. the description fairly presents the [*type or name of*] system that was designed and implemented throughout the period [*date*] to [*date*].

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period [*date*] to [*date*].

c. the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [*date*] to [*date*].

Description of tests of controls

The specific controls tested and the nature, timing, and results of those tests are listed on pages [*yy–zz*].

Restricted use

This report, including the description of tests of controls and results thereof on pages [*yy–zz*], is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system during some or all of the period [*date*] to [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: Example 1 in paragraph .A68 of AT section 801, *Reporting on Controls at a Service Organization* (AICPA, *Professional Standards*)]

.23 Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 2 Report)—Complementary User Entity Controls are Needed to Achieve the Control Objectives

Independent Service Auditor's Report

To XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] throughout the period [*date*] to [*date*] (description) and the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description. The description indicates that certain control objectives specified in the description can be achieved only if complementary user entity controls contemplated in the design of XYZ Service Organization's controls are suitably designed and operating effectively, along with related controls at the service organization. We have not evaluated the suitability of the design or operating effectiveness of such complementary user entity controls.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for the assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.[32]

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description throughout the period [*date*] to [*date*].

An examination of a description of a service organization's system and the suitability of the design and operating effectiveness of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description and the suitability of the design and operating effectiveness of those controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the related control objectives stated in the description were achieved. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page *[aa]*. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

[32] See footnote 31.

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Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. Also, the projection to the future of any evaluation of the fairness of the presentation of the description, or conclusions about the suitability of the design or operating effectiveness of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become inadequate or fail.

Opinion

In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion on page [*aa*],

a. the description fairly presents the [*type or name of*] system that was designed and implemented throughout the period [*date*] to [*date*].

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period [*date*] to [*date*] and user entities applied the complementary user entity controls contemplated in the design of XYZ Service Organization's controls throughout the period [*date*] to [*date*].

c. the controls tested, which together with the complementary user entity controls referred to in the scope paragraph of this report, if operating effectively, were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [*date*] to [*date*].

The specific controls tested [*including certain complementary user entity controls*] and the nature, timing, and results of those tests are listed on pages [*yy–zz*].

Restricted use

This report, including the description of tests of controls and results thereof on pages [*yy–zz*], is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system during some or all of the period [*date*] to [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: Derived from example 1 in paragraph .A68 of AT section 801]

.24 Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 2 Report)—Qualified Opinion—Description of the Service Organization's System is Not Fairly Presented in All Material Respects

Independent Service Auditor's Report

To XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] throughout the period [*date*] to [*date*] (description) and the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for the assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.[33]

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description throughout the period [*date*] to [*date*].

An examination of a description of a service organization's system and the suitability of the design and operating effectiveness of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description and the suitability of the design and operating effectiveness of those controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the related control objectives stated in the description were achieved. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page *[aa]*. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. Also, the projection to the future of any evaluation of the fairness of the presentation of the description, or conclusions about the suitability of the design or operating effectiveness of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become inadequate or fail.

[33] See footnote 31.

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Basis for qualified opinion

The accompanying description states on page [*mn*] that XYZ Service Organization uses operator identification numbers and passwords to prevent unauthorized access to the system. Based on inquiries of staff personnel and observation of activities, we have determined that operator identification numbers and passwords are employed in applications A and B but are not required to access the system in applications C and D.

Opinion

In our opinion, except for the matter described in the preceding paragraph, and based on the criteria described in XYZ Service Organization's assertion on page [*aa*], in all material respects,

a. the description fairly presents the [*type or name of*] system that was designed and implemented throughout the period [*date*] to [*date*].

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period [*date*] to [*date*].

c. the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [*date*] to [*date*].

The specific controls tested and the nature, timing, and results of those tests are listed on pages [*yy–zz*].

Restricted use

This report, including the description of tests of controls and results thereof on pages [*yy–zz*], is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system during some or all of the period [*date*] to [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: Example 1 in paragraph .A68 of AT section 801 and example 1 in paragraph .A69 of AT section 801]

.25 Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 2 Report)—Qualified Opinion—Controls Were Not Suitably Designed to Provide Reasonable Assurance That the Control Objectives Stated in the Description of the Service Organization's System Would be Achieved if the Controls Operated Effectively

Independent Service Auditor's Report

To XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] throughout the period [*date*] to [*date*] (description) and the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for the assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.[34]

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description throughout the period [*date*] to [*date*].

An examination of a description of a service organization's system and the suitability of the design and operating effectiveness of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description and the suitability of the design and operating effectiveness of those controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the related control objectives stated in the description were achieved. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page *[aa]*. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. Also, the projection to the future of any evaluation of the fairness of the presentation of the description, or

[34] See footnote 31.

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conclusions about the suitability of the design or operating effectiveness of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become inadequate or fail.

Basis for qualified opinion

As discussed on page [*mn*] of the accompanying description, from time to time, XYZ Service Organization makes changes in application programs to correct deficiencies or to enhance capabilities. The procedures followed in determining whether to make changes, in designing the changes, and in implementing them do not include review and approval by authorized individuals who are independent from those involved in making the changes. There also are no specified requirements to test such changes or provide test results to an authorized reviewer prior to implementing the changes. As a result the controls are not suitably designed to achieve the control objective, "Controls provide reasonable assurance that changes to existing applications are authorized, tested, approved, properly implemented, and documented."

Opinion paragraph

In our opinion, except for the matter described in the preceding paragraph, and based on the criteria described in XYZ Service Organization's assertion on page [*aa*], in all material respects,

a. the description fairly presents the [*type or name of*] system that was designed and implemented throughout the period [*date*] to [*date*].

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period [*date*] to [*date*].

c. the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [*date*] to [*date*].

The specific controls tested and the nature, timing, and results of those tests are listed on pages [*yy–zz*].

Restricted use

This report, including the description of tests of controls and results thereof on pages [*yy–zz*], is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system during some or all of the period [*date*] to [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: Example 1 in paragraph .A68 of AT section 801 and example 2 in paragraph .A69 of AT section 801]

.26 Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 2 Report)—Qualified Opinion—Controls Were Not Operating Effectively Throughout the Specified Period to Achieve the Control Objectives Stated in the Description of the Service Organization's System

Independent Service Auditor's Report

To XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] throughout the period [*date*] to [*date*] (description) and the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for the assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.[35]

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description throughout the period [*date*] to [*date*].

An examination of a description of a service organization's system and the suitability of the design and operating effectiveness of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description and the suitability of the design and operating effectiveness of those controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the related control objectives stated in the description were achieved. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page *[aa]*. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. Also, the projection to the future of any evaluation of the fairness of the presentation of the description, or

[35] See footnote 31.

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conclusions about the suitability of the design or operating effectiveness of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become inadequate or fail.

Basis for qualified opinion

XYZ Service Organization states in its description that it has automated controls in place to reconcile loan payments received with the various output reports. However, as noted on page [*mn*] of the description of tests of controls and results thereof, this control was not operating effectively throughout the period [*date*] to [*date*] due to a programming error. This resulted in the nonachievement of the control objective, "Controls provide reasonable assurance that loan payments received are properly recorded" throughout the period January 1, 20X1, to April 30, 20X1. XYZ Service Organization implemented a change to the program performing the calculation as of May 1, 20X1, and our tests indicate that it was operating effectively throughout the period May 1, 20X1, to December 31, 20X1.

Opinion

In our opinion, except for the matter described in the preceding paragraph, and based on the criteria described in XYZ Service Organization's assertion on page [*aa*], in all material respects,

a. the description fairly presents the [*type or name of*] system that was designed and implemented throughout the period [*date*] to [*date*].

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period [*date*] to [*date*].

c. the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [*date*] to [*date*].

The specific controls tested and the nature, timing, and results of those tests are listed on pages [*yy–zz*].

Restricted use

This report, including the description of tests of controls and results thereof on pages [*yy–zz*], is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system during some or all of the period [*date*] to [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: Example 1 in paragraph .A68 of AT section 801 and example 3 in paragraph .A69 of AT section 801]

.27 Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 2 Report)—Qualified Opinion—Scope Limitation—Service Auditor is Unable to Obtain Sufficient Appropriate Evidence Regarding the Operating Effectiveness of Controls

Independent Service Auditor's Report

To XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] throughout the period [*date*] to [*date*] (description) and the suitability of the design and operating effectiveness of controls to achieve the related control objectives stated in the description.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for the assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.[36]

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design and operating effectiveness of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance about whether, in all material respects, the description is fairly presented and the controls were suitably designed and operating effectively to achieve the related control objectives stated in the description throughout the period [*date*] to [*date*].

An examination of a description of a service organization's system and the suitability of the design and operating effectiveness of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description and the suitability of the design and operating effectiveness of those controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed or operating effectively to achieve the related control objectives stated in the description. Our procedures also included testing the operating effectiveness of those controls that we consider necessary to provide reasonable assurance that the related control objectives stated in the description were achieved. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page *[aa]*. We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. Also, the projection to the future of any evaluation of the fairness of the presentation of the description, or

[36] See footnote 31.

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conclusions about the suitability of the design or operating effectiveness of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become inadequate or fail.

Basis for qualified opinion

XYZ Service Organization states in its description that it has automated controls in place to reconcile loan payments received with the output generated. However, electronic records of the performance of this reconciliation for the period from [*date*] to [*date*] were deleted as a result of a computer processing error and, therefore, we were unable to test the operation of this control for that period. Consequently, we were unable to determine whether the control objective, "Controls provide reasonable assurance that loan payments received are properly recorded" was achieved throughout the period [*date*] to [*date*].

Opinion

In our opinion, except for the matter described in the preceding paragraph, and based on the criteria described in XYZ Service Organization's assertion on page [*aa*], in all material respects,

a. the description fairly presents the [*type or name of*] system that was designed and implemented throughout the period [*date*] to [*date*].

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively throughout the period [*date*] to [*date*].

c. the controls tested, which were those necessary to provide reasonable assurance that the control objectives stated in the description were achieved, operated effectively throughout the period [*date*] to [*date*].

The specific controls tested and the nature, timing, and results of those tests are listed on pages [*yy–zz*].

Restricted use

This report, including the description of tests of controls and results thereof on pages [*yy–zz*], is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system during some or all of the period [*date*] to [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when assessing the risks of material misstatements of user entities' financial statements. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: Example 1 in paragraph .A68 of AT section 801 and example 4 in paragraph .A69 of AT section 801]

.28 Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 1 Report)

Independent Service Auditor's Report

To: XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] as of [*date*], and the suitability of the design of controls to achieve the related control objectives stated in the description.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design of the controls to achieve the related controls objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for its assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.[37]

Service auditor'sresponsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance, in all material respects, about whether the description is fairly presented and the controls were suitably designed to achieve the related control objectives stated in the description as of [*date*].

An examination of a description of a service organization's system and the suitability of the design of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description of the system and the suitability of the design of the controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed to achieve the related control objectives stated in the description. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page *[aa]*.

We did not perform any procedures regarding the operating effectiveness of the controls stated in the description and, accordingly, do not express an opinion thereon.

We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. The projection to the future of any evaluation of the fairness of the presentation of the description, or any conclusions about the suitability of the design of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become ineffective or fail.

Opinion

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[37] See footnote 31.

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In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion,

a. the description fairly presents the [*type or name of*] system that was designed and implemented as of [*date*], and

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively as of [*date*].

Restricted use

This report is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system as of [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when obtaining an understanding of user entities information and communication systems relevant to financial reporting. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: Example 2 in paragraph .A68 of AT section 801]

.29 Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 1 Report)—Complementary User Entity Controls are Needed to Achieve the Control Objectives

Independent Service Auditor's Report

To XYZ Service Organization

Scope

We have examined XYZ Service Organization's description of its [*type or name of*] system for processing user entities' transactions [*or identification of the function performed by the system*] as of [*date*] (description), and the suitability of the design of controls to achieve the related control objectives stated in the description. The description indicates that certain complementary user entity controls must be suitably designed and implemented at user entities for related controls at the service organization to be considered suitably designed to achieve the related control objectives. We have not evaluated the suitability of the design or operating effectiveness of such complementary user entity controls.

Service organization's responsibilities

On page XX of the description, XYZ Service Organization has provided an assertion about the fairness of the presentation of the description and suitability of the design of the controls to achieve the related controls objectives stated in the description. XYZ Service Organization is responsible for preparing the description and for its assertion, including the completeness, accuracy, and method of presentation of the description and the assertion, providing the services covered by the description, specifying the control objectives and stating them in the description, identifying the risks that threaten the achievement of the control objectives, selecting the criteria, and designing, implementing, and documenting controls to achieve the related control objectives stated in the description.[38]

Service auditor's responsibilities

Our responsibility is to express an opinion on the fairness of the presentation of the description and on the suitability of the design of the controls to achieve the related control objectives stated in the description, based on our examination. We conducted our examination in accordance with attestation standards established by the American Institute of Certified Public Accountants. Those standards require that we plan and perform our examination to obtain reasonable assurance, in all material respects, about whether the description is fairly presented and the controls were suitably designed to achieve the related control objectives stated in the description as of [*date*].

An examination of a description of a service organization's system and the suitability of the design of the service organization's controls to achieve the related control objectives stated in the description involves performing procedures to obtain evidence about the fairness of the presentation of the description of the system and the suitability of the design of the controls to achieve the related control objectives stated in the description. Our procedures included assessing the risks that the description is not fairly presented and that the controls were not suitably designed to achieve the related control objectives stated in the description. An examination engagement of this type also includes evaluating the overall presentation of the description and the suitability of the control objectives stated therein, and the suitability of the criteria specified by the service organization and described at page *[aa]*.

We did not perform any procedures regarding the operating effectiveness of the controls stated in the description and, accordingly, do not express an opinion thereon.

We believe that the evidence we obtained is sufficient and appropriate to provide a reasonable basis for our opinion.

Inherent limitations

[38] See footnote 31.

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Because of their nature, controls at a service organization may not prevent, or detect and correct, all errors or omissions in processing or reporting transactions [*or identification of the function performed by the system*]. The projection to the future of any evaluation of the fairness of the presentation of the description, or any conclusions about the suitability of the design of the controls to achieve the related control objectives is subject to the risk that controls at a service organization may become ineffective or fail.

Opinion

In our opinion, in all material respects, based on the criteria described in XYZ Service Organization's assertion,

a. the description fairly presents the [*type or name of*] system that was designed and implemented as of [*date*], and

b. the controls related to the control objectives stated in the description were suitably designed to provide reasonable assurance that the control objectives would be achieved if the controls operated effectively as of [*date*] and user entities applied the complementary user entity controls contemplated in the design of XYZ Service Organization's controls as of [*date*].

Restricted use

This report is intended solely for the information and use of XYZ Service Organization, user entities of XYZ Service Organization's [*type or name of*] system as of [*date*], and the independent auditors of such user entities, who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when obtaining an understanding of user entities information and communication systems relevant to financial reporting. This report is not intended to be and should not be used by anyone other than these specified parties.

[*Service auditor's signature*]

[*Date of the service auditor's report*]

[*Service auditor's city and state*]

[Source: Derived from example 2 in paragraph .A68 of AT section 801]

.30 Illustrative Assertion by Management of a Service Organization for an Engagement to Report on a Description of a Service Organization's System and the Suitability of the Design and Operating Effectiveness of Controls (Type 2 Engagement)

XYZ Service Organization's Assertion

We have prepared the description of XYZ Service Organization's [*type or name of*] system (description) for user entities of the system during some or all of the period [*date*] to [*date*], and their user auditors who have a sufficient understanding to consider it, along with other information, including information about controls implemented by user entities of the system themselves, when assessing the risks of material misstatements of user entities' financial statements. We confirm, to the best of our knowledge and belief, that

a. the description fairly presents the [*type or name of*] system made available to user entities of the system during some or all of the period [*date*] to [*date*] for processing their transactions [*or identification of the function performed by the system*]. The criteria we used in making this assertion were that the description

i. presents how the system made available to user entities of the system was designed and implemented to process relevant transactions, including

(1) the classes of transactions processed.

(2) the procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, and transferred to the reports presented to user entities of the system.

(3) the related accounting records, supporting information, and specific accounts that are used to initiate, authorize, record, process, and report transactions; this includes the correction of incorrect information and how information is transferred to the reports presented to user entities of the system.

(4) how the system captures and addresses significant events and conditions, other than transactions.

(5) the process used to prepare reports or other information provided to user entities' of the system.

(6) specified control objectives and controls designed to achieve those objectives.

(7) other aspects of our control environment, risk assessment process, information and communication systems (including the related business processes), control activities, and monitoring controls that are relevant to processing and reporting transactions of user entities of the system.

ii. does not omit or distort information relevant to the scope of the [*type or name of*] system, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities of the system and the independent auditors of those user entities, and may not, therefore, include every aspect of the [*type or name of*] system that each individual user entity of the system and its auditor may consider important in its own particular environment.

b. the description includes relevant details of changes to the service organization's system during the period covered by the description when the description covers a period of time.

c. the controls related to the control objectives stated in the description were suitably designed and operated effectively throughout the period [*date*] to [*date*] to achieve those control objectives. The criteria we used in making this assertion were that

i. the risks that threaten the achievement of the control objectives stated in the description have been identified by the service organization;

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ii. the controls identified in the description would, if operating as described, provide reasonable assurance that those risks would not prevent the control objectives stated in the description from being achieved; and

iii. the controls were consistently applied as designed, including whether manual controls were applied by individuals who have the appropriate competence and authority.

[Source: Example 1 in paragraph .A71 of AT section 801]

.31 Illustrative Assertion by Management of a Service Organization for an Engagement to Report on a Description of a Service Organization's System and the Suitability of the Design of Controls (Type 1 Engagement)

XYZ Service Organization's Assertion

We have prepared the description of XYZ Service Organization's [*type or name of*] system (description) for user entities of the system as of [*date*], and their user auditors who have a sufficient understanding to consider it, along with other information including information about controls implemented by user entities themselves, when obtaining an understanding of user entities' information and communication systems relevant to financial reporting. We confirm, to the best of our knowledge and belief, that

a. the description fairly presents the [*type or name of*] system made available to user entities of the system as of [*date*] for processing their transactions [*or identification of the function performed by the system*]. The criteria we used in making this assertion were that the description

  i. presents how the system made available to user entities of the system was designed and implemented to process relevant transactions, including

    (1) the classes of transactions processed.

    (2) the procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, and transferred to the reports presented to user entities of the system.

    (3) the related accounting records, supporting information, and specific accounts that are used to initiate, authorize, record, process, and report transactions; this includes the correction of incorrect information and how information is transferred to the reports provided to user entities of the system.

    (4) how the system captures and addresses significant events and conditions, other than transactions.

    (5) the process used to prepare reports or other information provided to user entities of the system.

    (6) specified control objectives and controls designed to achieve those objectives.

    (7) other aspects of our control environment, risk assessment process, information and communication systems (including the related business processes), control activities, and monitoring controls that are relevant to processing and reporting transactions of user entities of the system.

  ii. does not omit or distort information relevant to the scope of the [*type or name of*] system, while acknowledging that the description is prepared to meet the common needs of a broad range of user entities of the system and the independent auditors of those user entities, and may not, therefore, include every aspect of the [*type or name of*] system that each individual user entity of the system and its auditor may consider important in its own particular environment.

b. the controls related to the control objectives stated in the description were suitably designed as of [*date*] to achieve those control objectives. The criteria we used in making this assertion were that

  i. the risks that threaten the achievement of the control objectives stated in the description have been identified by the service organization.

  ii. the controls identified in the description would, if operating as described, provide reasonable assurance that those risks would not prevent the control objectives stated in the description from being achieved.

[Source: Example 2 in paragraph .A71 of AT section 801]

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.32 Reports on Internal Control Required by Securities and Exchange Commission Rule 17a-5(g)(1)

The following is an illustration of the independent auditor's report on internal control required by Securities and Exchange Commission (SEC) Rule 17a-5(g)(1).[39]

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g), in the following:

a. 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)

b. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13

c. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

d. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls, and of the practices and procedures referred to in the preceding paragraph, and to assess whether those practices and procedures can be expected to achieve the SEC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted

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[39] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), replaces this sentence with the following sentence: "We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States)." On May 14, 2004, the Securities and Exchange Commission (SEC) issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 14, 2004, references in SEC rules and staff guidance and in the federal securities laws to generally accepted auditing standards (GAAS) or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The guidance in this release is applicable only to auditors' engagements that are governed by PCAOB rules. The PCAOB, for example, has not established particular auditing standards for nonissuer broker-dealers or investment advisers. This release is not applicable to such engagements and related filings.

The staff of the PCAOB published a series of questions and answers on PCAOB Auditing Standard No. 1. See the PCAOB website at www.pcaob.org for more information.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also is revising AU section 508 in light of the International Auditing and Assurance Standards Board's recently exposed International Standard on Auditing *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements* and PCAOB Auditing Standard No. 1. See the AICPA website at www.aicpa.org/Research/Standards/AuditAttest/Pages/audit%20and%20attest%20standards.aspx for more information.

accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined previously.[40]

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X1, to meet the SEC's objectives.[41]

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X2

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, updated as of July 1, 2010, appendix C]

Note: Section 9650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

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[40] Paragraph .28 of AU section 325 notes that if significant deficiencies are identified, this paragraph may be modified by inserting, "However, we identified certain deficiencies in internal control that we consider to be significant deficiencies, and communicated them in writing to management and those charged with governance on [date]." Paragraph .25 of AU section 325 states that the auditor should not issue a written communication stating that no significant deficiencies were identified because of the potential for misinterpretation of the limited degree of assurance provided by such a communication.

If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of this paragraph of the report should be modified as follows:

> However, we identified the following deficiencies in [*internal control or control activities for safeguarding securities*] that we consider to be material weaknesses, as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures performed in our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X2, and this report does not affect our report thereon dated February 15, 20Y1. [*A description of the material weaknesses that have come to the auditor's attention and corrective action.*]

[41] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 40. 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.

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.33 Report on Internal Control Required by SEC Rule 17a-5 (g) (1) for a Broker-Dealer Claiming an Exemption From SEC Rule 15c3-3

The following is an illustration of an independent auditor's report on internal control of a broker-dealer claiming an exemption from SEC Rule 15c3-3.[42, 43]

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding securities. This study included tests of such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g) in making the periodic computations of aggregate indebtedness (or aggregate debits) and net capital under Rule 17a-3(a)(11) and for determining compliance with the exemptive provisions of Rule 15c3-3. Because the Company does not carry securities accounts for customers or perform custodial functions relating to customer securities, we did not review the practices and procedures followed by the Company in any of the following:

a. Making quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by Rule 17a-13

b. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the SEC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

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[42] For audits conducted in accordance with PCAOB standards, see footnote 39.

[43] There are different types of exemptions under SEC Rule 15c3-3-k(1),k(2)(i), and k(2)(ii). Other formats of this letter will be required depending on the type of exemption filed.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first and second paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities that we consider to be material weaknesses, as defined previously.[44]

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the SEC to be adequate for its purposes in accordance with the Securities Exchange Act of 1934 and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second paragraph of this report, were adequate at December 31, 20X1, to meet the SEC's objectives.[45]

This report is intended solely for the information and use of the Board of Directors, management, the SEC, [*Designated self-regulatory organization*], and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 in their regulation of registered brokers and dealers, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X2

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, updated as of July 1, 2010, appendix D]

Note: Section 9650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

[44] See footnote 40.
[45] See footnote 41.

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.34 Letter to SEC When the Broker-Dealer Has Not Made the Required Notification

The following report is appropriate if the broker-dealer has not made the required notification of material inadequacy or if the auditor does not agree with the statements therein. Modification of this letter may be required based on the facts and circumstances of the particular situation.

Securities and Exchange Commission
Washington D.C., and [*Appropriate regional office*]
Designated Examining Authority

Dear Sirs:

Our most recent audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company), was as of December 31, 20X0, and for the year then ended, which we reported on under date of February 15, 20X1. We have not audited any financial statements of the Company as of any date or for any period subsequent to December 31, 20X0. Although we are presently performing certain procedures as part of our audit of the [*consolidated*] financial statements of the Company as of December 31, 20X1, and for the year then ending, these procedures do not constitute all the procedures necessary in an audit conducted in accordance with auditing standards generally accepted in the United States of America or all the procedures necessary to (1) consider the Company's internal control as required by 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 the Company is responsible for establishing and maintaining internal control. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls. The objectives of internal control are to provide management with reasonable but not absolute assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and are recorded properly to permit the preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in internal control, error or fraud may occur and not be detected. Also, projection of any evaluation of internal control to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the effectiveness of the design and operation of controls may deteriorate.

The purpose of performing certain procedures prior to the date of the financial statements is to facilitate the expression of an opinion on the Company's financial statements. It must be understood that the procedures performed would not necessarily identify all material weaknesses in internal control and control activities for safeguarding securities.

However, pursuant to the requirements of Rule 17a-5(h)(2), we are to call to the attention of the chief financial officer any weaknesses that we believe to be material and that were disclosed during the course of interim work. We have made such notification to the chief financial officer of Standard Stockbrokerage Co., Inc., and we believe the following additional information is required pursuant to the requirements of the rule.

[*List and describe all instances where the independent auditor did not agree with the notification of the broker or dealer or where the required notification was not made.*]

Accounting Firm
New York, New York
December 10, 20X1

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, updated as of July 1, 2010, appendix E]

Note: Section 9650 illustrates the auditor's reports on the financial statements of brokers and dealers in securities.

.35 Report on Internal Control Required by CFTC Regulation 1.16 and SEC Rule 17a-5(g)(1)

The following is an illustration of the independent auditor's report on internal control required by Commodity Futures Trading Commission Regulation 1.16 and SEC Rule 17a-5(g)(1).[46]

Board of Directors
Standard Stockbrokerage Co., Inc.:

In planning and performing our audit of the [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] (the Company) as of and for the year ended December 31, 20X1, in accordance with auditing standards generally accepted in the United States of America, we considered the Company's internal control over financial reporting (internal control) as a basis for designing our auditing procedures for the purpose of expressing our opinion on the [*consolidated*] financial statements, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control. Accordingly, we do not express an opinion on the effectiveness of the Company's internal control.

Also, as required by Rule 17a-5(g)(1) of the Securities and Exchange Commission (SEC), we have made a study of the practices and procedures followed by the Company, including consideration of control activities for safeguarding securities. This study included tests of compliance with such practices and procedures that we considered relevant to the objectives stated in Rule 17a-5(g), in the following:

a. 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)

b. Making the quarterly securities examinations, counts, verifications, and comparisons, and the recordation of differences required by Rule 17a-13

c. Complying with the requirements for prompt payment for securities under Section 8 of Federal Reserve Regulation T of the Board of Governors of the Federal Reserve System

d. Obtaining and maintaining physical possession or control of all fully paid and excess margin securities of customers as required by Rule 15c3-3

In addition, as required by Regulation 1.16 of the Commodity Futures Trading Commission (CFTC), we have made a study of the practices and procedures followed by the Company including consideration of control activities for safeguarding customer and firm assets. This study included tests of such practices and procedures that we considered relevant to the objectives stated in Regulation 1.16, in making the following:

a. The periodic computations of minimum financial requirements pursuant to Regulation 1.17

b. The daily computations of the segregation requirements of Section 4d(a)(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations

c. The daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the CFTC

The management of the Company is responsible for establishing and maintaining internal control and the practices and procedures referred to in the preceding paragraphs. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of controls and of the practices and procedures referred to in the preceding paragraphs and to assess whether those practices and procedures can be expected to achieve the SEC's and the CFTC's previously mentioned objectives. Two of the objectives of internal control and the practices and procedures are to provide management with reasonable but not absolute assurance that assets for which the Company has responsibility are safeguarded against loss from unauthorized use or disposition, and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles. Rule 17a-5(g) and Regulation 1.16(d)(2) list additional objectives of the practices and procedures listed in the preceding paragraphs.

[46] For audits conducted in accordance with PCAOB standards, see footnote 39.

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Because of inherent limitations in internal control and the practices and procedures referred to above, error or fraud may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

A *control deficiency* exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A *significant deficiency* is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

A *material weakness* is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected and corrected on a timely basis.

Our consideration of internal control was for the limited purpose described in the first, second and third paragraphs and would not necessarily identify all deficiencies in internal control that might be material weaknesses. We did not identify any deficiencies in internal control and control activities for safeguarding securities and certain regulated commodity customer and firm assets that we consider to be material weaknesses, as defined previously.[47]

We understand that practices and procedures that accomplish the objectives referred to in the second and third paragraphs of this report are considered by the SEC and CFTC to be adequate for their purposes in accordance with the Securities Exchange Act of 1934, the Commodity Exchange Act, and related regulations, and that practices and procedures that do not accomplish such objectives in all material respects indicate a material inadequacy for such purposes. Based on this understanding and on our study, we believe that the Company's practices and procedures, as described in the second and third paragraphs of this report, were adequate at December 31, 20X1, to meet the SEC's and CFTC's objectives.[48]

This report is intended solely for the information and use of the Board of Directors, management, the SEC, the CFTC, [*Designated Self-Regulatory Organization*] and other regulatory agencies that rely on Rule 17a-5(g) under the Securities Exchange Act of 1934 or Regulation 1.16 of the CFTC or both in their regulation of registered broker-dealers and futures commission merchants, and is not intended to be and should not be used by anyone other than these specified parties.

Accounting Firm
New York, New York
February 15, 20X2

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, updated as of July 1, 2010, appendix F]

[*The next page is 9521.*]

[47] See footnote 40.

[48] Whenever inadequacies are described, the last sentence of this paragraph should be modified as per footnote 40. The report should also describe material inadequacies that the auditor becomes aware of that existed during the period but were corrected prior to the end of the period, unless management already has reported them to the SEC and the Commodity Futures Trading Commission.

AAM Section 9260

Special Reports

.01 Cash Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and the related statements of revenue collected and expenses paid for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets and liabilities arising from cash transactions of XYZ Company as of December 31, 20X2 and 20X1, and its revenue collected and expenses paid during the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 623, *Special Reports* (AICPA, *Professional Standards*)]

.02 Income Tax Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of assets, liabilities, and capital—income tax basis of ABC Partnership as of December 31, 20X2 and 20X1, and the related statements of revenue and expenses—income tax basis and of changes in partners' capital accounts—income tax basis for the years then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the assets, liabilities, and capital of ABC Partnership as of [*at*] December 31, 20X2 and 20X1, and its revenue and expenses and changes in partners' capital accounts for the years then ended, on the basis of accounting described in Note X.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 623][1]

[1] In July 2010, the AICPA issued Technical Questions and Answers section 1400.33, "Combining Financial Statements Prepared in Accordance With the Income Tax Basis of Accounting" (AICPA, *Technical Practice Aids*), which states that, in the case of brother-sister corporations in which each entity maintains its books and records on the basis of accounting used, or expected to be used, to file each entity's income tax return, AU section 623, *Special Reports* (AICPA, *Professional Standards*), does not preclude the auditor from reporting on combining financial statements as long as the basis of accounting for each of the entities presented is the basis that they use, or expect to use, to file their income tax returns.

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.03 Regulatory (Statutory) Basis Statements

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the related statements of income and cash flows—statutory basis and changes in surplus—statutory basis for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the board of directors and management of XYZ Insurance Company and [*name of regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .08 of AU section 623]

.04 Report Relating to Amount of Sales for the Purpose of Computing Rental

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited the accompanying schedule of gross sales (as defined in the lease agreement dated March 4, 20XX, between ABC Company, as lessor, and XYZ Stores Corporation, as lessee) of XYZ Stores Corporation at its Main Street store, [*City*], [*State*], for the year ended December 31, 20X2. This schedule is the responsibility of XYZ Stores Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

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

In our opinion, the schedule of gross sales referred to above presents fairly, in all material respects, the gross sales of XYZ Stores Corporation at its Main Street store, [*City*], [*State*], for the year ended December 31, 20X2, as defined in the lease agreement referred to in the first paragraph.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Stores Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .18 of AU section 623]

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.05 Royalties

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited the accompanying schedule of royalties applicable to engine production of the Q Division of XYZ Corporation for the year ended December 31, 20X2, under the terms of a license agreement dated May 14, 20XX, between ABC Company and XYZ Corporation. This schedule is the responsibility of XYZ Corporation's management. Our responsibility is to express an opinion on this schedule based on our audit.

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

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

In our opinion, the schedule of royalties referred to above presents fairly, in all material respects, the number of engines produced by the Q Division of XYZ Corporation during the year ended December 31, 20X2, and the amount of royalties applicable thereto, under the license agreement referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Corporation and ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .18 of AU section 623]

.06 Profit Participation[2]

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company for the year ended December 31, 20X1, and have issued our report thereon dated March 10, 20X2. We have also audited XYZ Company's schedule of John Smith's profit participation for the year ended December 31, 20X1. This schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on this schedule based on our audit.

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

We have been informed that the documents that govern the determination of John Smith's profit participation are (*a*) the employment agreement between John Smith and XYZ Company dated February 1, 20X0, (*b*) the production and distribution agreement between XYZ Company and Television Network Incorporated dated March 1, 20X0, and (*c*) the studio facilities agreement between XYZ Company and QRX Studios dated April 1, 20X0, as amended November 1, 20X0.

In our opinion, the schedule of profit participation referred to above presents fairly, in all material respects, John Smith's participation in the profits of XYZ Company for the year ended December 31, 20X1, in accordance with the provisions of the agreements referred to above.

This report is intended solely for the information and use of the boards of directors and managements of XYZ Company and John Smith and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .18 of AU section 623]

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

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.07 Report on Federal and State Income Taxes Included in Financial Statements[3]

(Report on one or more specified elements, accounts, or items of a financial statement)

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company, Inc., for the year ended June 30, 20XX, and have issued our report thereon dated August 15, 20XX. We have also audited the current and deferred provision for the Company's federal and state income taxes for the year ended June 30, 20XX, included in those financial statements, and the related asset and liability tax accounts as of June 30, 20XX. This income tax information is the responsibility of the Company's management. Our responsibility is to express an opinion on it based on our audit.

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

In our opinion, the Company has paid or, in all material respects, made adequate provision in the financial statements referred to above for the payment of all federal and state income taxes and for related deferred income taxes that could be reasonably estimated at the time of our audit of the financial statements of XYZ Company, Inc., for the year ended June 30, 20XX.

[*Signature*]

[*Date*]

[Source: Paragraph .18 of AU section 623]

[3] See footnote 2.

.08 Report in Connection With a Proposed Acquisition

Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Board of Directors and Management of X Company:

We have performed the procedures enumerated below, which were agreed to by the Board of Directors and Management of X Company, solely to assist you in connection with the proposed acquisition of Y Company as of December 31, 20XX. Y Company is responsible for its cash and accounts receivable records. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the parties specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and the associated findings are as follows:

Cash

1. We obtained confirmation of the cash on deposit from the following banks, and we agreed the confirmed balance to the amount shown on the bank reconciliations maintained by Y Company. We mathematically checked the bank reconciliations and compared the resultant cash balances per book to the respective general ledger account balances.

Bank	*General Ledger Account Balances as of December 31, 20XX*
ABC National Bank	$5,000
DEF State Bank	3,776
XYZ Trust Company regular account	86,912
XYZ Trust Company payroll account	5,000
	$110,688

We found no exceptions as a result of the procedures.

Accounts Receivable

2. We added the individual customer account balances shown in an aged trial balance of accounts receivable (identified as Exhibit A) and compared the resultant total with the balance in the general ledger account.

We found no difference.

3. We compared the individual customer account balances shown in the aged trial balance of accounts receivable (Exhibit A) as of December 31, 19XX, to the balances shown in the accounts receivable subsidiary ledger.

We found no exceptions as a result of the comparisons.

4. We traced the aging (according to invoice dates) for 50 customer account balances shown in Exhibit A to the details of outstanding invoices in the accounts receivable subsidiary ledger. The balances selected for tracing were determined by starting at the eighth item and selecting every fifteenth item thereafter.

We found no exceptions in the aging of the amounts of the 50 customer account balances selected. The sample size traced was 9.8 percent of the aggregate amount of the customer account balances.

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5. We mailed confirmations directly to the customers representing the 150 largest customer account balances selected from the accounts receivable trial balance, and we received responses as indicated below. We also traced the items constituting the outstanding customer account balance to invoices and supporting shipping documents for customers from which there was no reply. As agreed, any individual differences in a customer account balance of less than $300 were to be considered minor, and no further procedures were performed.

Of the 150 customer balances confirmed, we received responses from 140 customers; 10 customers did not reply. No exceptions were identified in 120 of the confirmations received. The differences disclosed in the remaining 20 confirmation replies were either minor in amount (as defined above) or were reconciled to the customer account balance without proposed adjustment thereto. A summary of the confirmation results according to the respective aging categories is as follows.

	Accounts Receivable December 31, 20XX		
Aging Categories	*Customer Account Balances*	*Confirmations Requested*	*Confirmations Received*
Current	$156,000	$ 76,000	$ 65,000
Past due:			
Less than one month:	60,000	30,000	19,000
One to three months	36,000	18,000	10,000
Over three months	48,000	48,000	8,000
	$300,000	$172,000	$102,000

We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on cash and accounts receivable. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the board of directors and management of X Company and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .48 of AT section 201, *Agreed-Upon Procedures Engagements* (AICPA, *Professional Standards*)]

.09 Report in Connection With Claims of Creditors

Independent Accountant's Report on Applying Agreed-Upon Procedures

To the Trustee of XYZ Company:

We have performed the procedures described below, which were agreed to by the Trustee of XYZ Company, with respect to the claims of creditors solely to assist you in determining the validity of claims of XYZ Company as of May 31, 20XX, as set forth in the accompanying Schedule A. XYZ Company is responsible for maintaining records of claims submitted by creditors of XYZ Company. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the party specified in this report. Consequently, we make no representation regarding the sufficiency of the procedures described below either for the purpose for which this report has been requested or for any other purpose.

The procedures and associated findings are as follows:

1. Compare the total of the trial balance of accounts payable at May 31, 20XX, prepared by XYZ Company, to the balance in the related general ledger account.

The total of the accounts payable trial balance agreed with the balance in the related general ledger account.

2. Compare the amounts for claims received from creditors (as shown in claim documents provided by XYZ Company) to the respective amounts shown in the trial balance of accounts payable. Using the data included in the claims documents and in XYZ Company's accounts payable detail records, reconcile any differences found to the accounts payable trial balance.

All differences noted are presented in column 3 of Schedule A. Except for those amounts shown in column 4 of Schedule A, all such differences were reconciled.

3. Obtain the documentation submitted by creditors in support of the amounts claimed and compare it to the following documentation in XYZ Company's files: invoices, receiving reports, and other evidence of receipt of goods or services.

No exceptions were found as a result of these comparisons.

We were not engaged to and did not conduct an audit, the objective of which would be the expression of an opinion on the claims of creditors set forth in the accompanying Schedule A. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Trustee of XYZ Company and is not intended to be and should not be used by anyone other than this specified party.

[*Signature*]

[*Date*]

[Source: Paragraph .48 of AT section 201]

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.10 Reporting on the Subject Matter

Independent Accountant's Report[4]

Addressee:

We have examined the accompanying XBRL Instance Document of XYZ Company, which reflects the data presented in the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended [*optional to include the location of the financial statements, such as "included in the Company's Form 10-K for the year ended December 31, 20XX"*]. XYZ Company's management is responsible for the XBRL Instance Document. Our responsibility is to express an opinion based on our examination.

We have also audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended, and in our report dated [*Month*] XX, 20XX, we expressed an unqualified opinion on those financial statements.[5, 6]

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the XBRL Instance Document and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, the XBRL Instance Document of XYZ Company referred to above accurately reflects, in all material respects, the data presented in the financial statements in conformity with [*identify the criteria—for example, specific XBRL taxonomy, such as the "XBRL U.S. Consumer and Industrial Taxonomy," and where applicable, the company extension taxonomy, such as "XYZ Company's extension taxonomy," and the XBRL International Technical Specifications 2.0*].

[*Signature*]

[*Date*]

[Example 1 in paragraph .55 of Interpretation No. 5, "Attest Engagements on Financial Information Included in XBRL Instance Documents," of AT section 101, *Attest Engagements* (AICPA, *Professional Standards*, AT sec. 9101 par. .47–.55)]

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[4] Financial information includes data presented in audited or reviewed financial statements or other financial information (for example, management's discussion and analysis).

[5] If the financial statements have been reviewed, the sentence would read: "We have also reviewed, in accordance with [*standards established by the American Institute of Certified Public Accountants*] [*Statements on Standards for Accounting and Review Services issued by the American Institute of Certified Public Accountants*], the financial statements of XYZ Company as of March 31, 20XX, and for the three months then ended, the objective of which was the expression of limited assurance on such financial statements, and issued our report thereon dated [*Month*] XX, 20XX, [*describe any modifications of such report*]."

If the financial information has not been audited or reviewed, no reference to a report is required. The sentence would read: "We were not engaged to and did not conduct an audit or review of the [*identify information*], the objectives of which would have been the expression of an opinion or limited assurance on such [*identify information*]. Accordingly, we do not express an opinion or any other assurance on [*it*] [*them*]."

[6] If the audit opinion on the related financial statements is other than unqualified, the practitioner should disclose that fact, and any substantive reasons therefore.

.11 Reporting on Management's Assertions

Independent Accountant's Report on Attest Engagements on Financial Information[7] Included in XBRL Instance Documents

Addressee:

We have examined management's assertion that [*identify the assertion—for example, the accompanying XBRL Instance Document accurately reflects the data presented in the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended in conformity with (identify the criteria—for example, specific XBRL taxonomy, such as the "XBRL U.S. Consumer and Industrial Taxonomy," and where applicable, the company extension taxonomy, such as "XYZ Company's extension taxonomy," and the XBRL International Technical Specifications 2.0)*]. XYZ Company's management is responsible for the assertion. Our responsibility is to express an opinion on the assertion based on our examination.

We have also audited, in accordance with auditing standards generally accepted in the United States of America, the financial statements of XYZ Company as of December 31, 20XX, and for the year then ended, and in our report dated [*Month*] XX, 20XX, we expressed an unqualified opinion on those financial statements.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting the XBRL Instance Document and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertion referred to above is fairly stated, in all material respects, in conformity with [*identify the criteria—for example, specific XBRL taxonomy, such as the "XBRL U.S. Consumer and Industrial Taxonomy," and where applicable, the company extension taxonomy, such as "XYZ Company's extension taxonomy," and the XBRL International Technical Specifications 2.0*].

[*Signature*]

[*Date*]

[Source: Example 2 in paragraph .55 of Interpretation No. 5 of AT section 101]

[7] See footnote 4.

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.12 Report on Compliance With Contractual Provisions (Given in a Separate Report)

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of XYZ Company as of December 31, 20X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated February 16, 20X3.

In connection with our audit, nothing came to our attention that caused us to believe that the Company failed to comply with the terms, covenants, provisions, or conditions of sections XX to XX, inclusive, of the Indenture dated July 21, 20X0, with ABC Bank insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the boards of directors and management of XYZ Company and ABC Bank and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .21 of AU section 623]

Note: When this report is included in the auditor's standard report accompanying financial statements, the last two paragraphs are examples of the paragraphs that should follow the opinion paragraph of the auditor's report on the financial statements.

.13 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 auditing standards generally accepted in the United States of America, the balance sheet of XYZ Company as of December 31, 20X2, and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated March 5, 20X3, which included an explanatory paragraph that described the litigation discussed in Note X of those statements.

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

This report is intended solely for the information and use of the board of directors and managements of XYZ Company and the [*name of state regulatory agency*] and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .21 of AU section 623]

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.14 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 special-purpose statement of assets and liabilities of ABC Company as of December 31, 20X2 and 20X1, and the related special-purpose statements of revenues and expenses and of cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

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

In our opinion, the special-purpose financial statements referred to above present fairly, in all material respects, the assets and liabilities of ABC Company at December 31, 20X2 and 20X1, and the revenues, expenses and cash flows for the years then ended, on the basis of accounting described in Note X.

This report is intended solely for the information and use of the boards of directors and management of ABC Company and DEF Bank and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .30 of AU section 623]

.15 Report on a Schedule of Gross Income and Certain Expenses to Meet Regulatory Requirements and to be Included in a Document Distributed to the General Public

Independent Auditor's Report

Addressee:

We have audited the accompanying Historical Summaries of Gross Income and Direct Operating Expenses of ABC Apartments, City, State (Historical Summaries), for each of the three years in the period ended December 31, 20XX. These Historical Summaries are the responsibility of the Apartments' management. Our responsibility is to express an opinion on the Historical Summaries based on our audits.

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

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

In our opinion, the Historical Summaries referred to above present fairly, in all material respects, the gross income and direct operating expenses described in Note X of ABC Apartments for each of the three years in the period ended December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*Date*]

[Source: Paragraph .26 of AU section 623]

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.16 Report on a Statement of Assets Sold and Liabilities Transferred to Comply With a Contractual Agreement

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of net assets sold of ABC Company as of June 8, 20XX. This statement of net assets sold is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the statement of net assets sold based on our audit.

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

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

In our opinion, the accompanying statement of net assets sold presents fairly, in all material respects, the net assets of ABC Company as of June 8, 20XX sold pursuant to the purchase agreement referred to in Note X, in conformity with accounting principles generally accepted in the United States of America.

This report is intended solely for the information and use of the boards of directors and managements of ABC Company and XYZ Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Paragraph .26 of AU section 623]

.17 Report on the Application of Accounting Principles

Introduction

We have been engaged to report on the appropriate application of accounting principles generally accepted in [*country of origin of such principles*] to the specific transaction described below. This report is being issued to ABC Company for assistance in evaluating accounting principles for the described specific transaction. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

Description of Transaction

The facts, circumstances, and assumptions relevant to the specific transaction as provided to us by the management of ABC Company are as follows:

Appropriate Accounting Principles

[*Text discussing generally accepted accounting principles*]

Concluding Comments

The ultimate responsibility for the decision on the appropriate application of accounting principles generally accepted in [*country of origin of such principles*] for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountant. Our judgment on the appropriate application of accounting principles generally accepted in [*country of origin of such principles*] for the described specific transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

Restricted Use

This report is intended solely for the information and use of the board of directors and management of ABC Company and is not intended to be and should not be used by anyone other than these specified parties.

[Source: Paragraph .11 of AU section 625, *Reports on the Application of Accounting Principles* (AICPA, *Professional Standards*)]

Notes: This illustrative report is intended for a reporting accountant either in connection with a proposal to obtain a new client or otherwise, should apply when preparing a written report on (1) the application of accounting principles to specified transactions, either completed or proposed, involving facts and circumstances of a specific entity ("specific transactions"), or (2) the type of opinion that may be rendered on a specific entity's financial statements.

[Source: Paragraph .03 of AU section 625]

Because of the nature of a transaction not involving facts or circumstances of a specific entity ("hypothetical transaction"), a reporting accountant cannot know, for example, whether the continuing accountant has reached a different conclusion on the application of accounting principles for the same or similar transaction, or how the specific entity has accounted for similar transactions in the past. Therefore an accountant should not undertake an engagement to provide a written report on the application of accounting principles to a hypothetical transaction.

[Source: Paragraph .04 of AU section 625]

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.18 Report on Financial Statements Presented in Conformity With a Prescribed Basis of Accounting (Property and Liability Insurance Company)

Independent Auditor's Report

To the Board of Directors
ABC Property and Liability Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America.[8] 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 more fully in Note X to the financial statements, the Company prepared these financial statements using accounting practices prescribed or permitted by the Insurance Department of the State of [*State of domicile*], which practices differ from accounting principles generally accepted in the United States of America. The effects on the financial statements of the variances between these statutory accounting practices and accounting principles generally accepted in the United States of America, although not reasonably determinable, are presumed to be material.

In our opinion, because of the effects of the matter discussed in the preceding paragraph, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ABC Property and Liability Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows[9] for the years then ended.

In our opinion, the financial statements referred to above present fairly, in all material respects, the admitted assets, liabilities, and surplus of ABC Property and Liability Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended, on the basis of accounting described in Note X.

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[8] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), replaces this sentence with the following sentence: "We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States)."

Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB Auditing Standards in audit reports when an auditor is engaged to perform the audit in accordance with both generally accepted auditing standards and PCAOB Auditing Standards. The Auditing Standards Board also has undertaken a project to determine what amendments, if any, should be made to AU section 508. See the AICPA website at www.aicpa.org/INTERESTAREAS/ACCOUNTINGANDAUDITING/RESOURCES/AUDATTEST/AUDATTESTSTNDRDS/Pages/AuditandAttestServices-Standards.aspx for more information.

This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing, and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

[9] Reference to cash flows would not be needed if the entity, under generally accepted accounting principles, is not required to present a statement of cash flows.

[*Firm Signature*]

Certified Public Accountants

[*City, State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Property and Liability Insurance Companies*, updated as of June 1, 2010, paragraph 8.32]

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.19 Report on Compliance With Contractual Provisions

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of *ABC Bank* (the "Bank") as of [*insert date—e.g.* December 31, 20XY], and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated [*insert date*].

In connection with our audit, nothing came to our attention that caused us to believe that the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), [[*and*] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)][10] of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated [*insert date*], insofar as they relate to accounting matters. However, our audit was not directed primarily toward obtaining knowledge of such noncompliance.

This report is intended solely for the information and use of the Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Example A of Technical Question and Answer (TIS) section 9110.16, "Example Reports on Federal Deposit Insurance Corporation Loss Sharing Purchase and Assumption Transactions" (AICPA, *Technical Practice Aids*)]

[10] Applicable depending on the nature of the agreement between the acquiring bank and the Federal Deposit Insurance Corporation.

.20 Report on Compliance With Contractual Provisions: Assuming Amended Computations Are Attached

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of *ABC Bank* (the "Bank") as of [*insert date—e.g.* December 31, 20XY], and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated [*insert date*].

In connection with our audit, after giving effect to the attached corrected computations, nothing came to our attention that caused us to believe that the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), [[*and*] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)][11] of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated [*insert date*], insofar as they relate to accounting matters. 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 Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Example B of TIS section 9110.16]

[11] See footnote 10.

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.21 Report on Compliance With Contractual Provisions: Noncompliance

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the balance sheet of *ABC Bank* (the "Bank") as of [*insert date—e.g.* December 31, 20XY], and the related statement of income, retained earnings, and cash flows for the year then ended, and have issued our report thereon dated [*insert date*].

In connection with our audit except as stated in the following sentence, nothing came to our attention that caused us to believe that the Bank failed to comply with the computational provisions of Exhibit 4.15A Single Family Shared-Loss Agreement, Article II section 2.1(b), [[*and*] Exhibit 4.15B, Commercial Shared-Loss Agreement, Article II section 2.1(a)][12] of the Purchase and Assumption agreement between the Bank and the Federal Deposit Insurance Corporation dated [*insert date*], insofar as they relate to accounting matters. The Bank did not comply with [*state computational provision not met*]. 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 Bank and the Federal Deposit Insurance Corporation and is not intended to be and should not be used by anyone other than these specified parties.

[*Signature*]

[*Date*]

[Source: Example C of TIS section 9110.16]

[*The next page is 9571.*]

[12] See footnote 10.

AAM Section 9270

Unaudited Financial Statements of a Public Entity

.01 Disclaimer

(When an accountant is associated with the financial statements but has not audited or reviewed such statements)

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: Paragraph .05 of AU section 504, *Association With Financial Statements* (AICPA, *Professional Standards*)]

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 nonissuer, this example is not appropriate.

.02 Current Period Financial Statements Unaudited—Prior Period Financial Statements Audited

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.

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: Paragraphs .05 and .16 of AU section 504]

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 nonissuer, this example is not appropriate.

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.03 Disclaimer—Cash Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of assets and liabilities resulting from cash transactions of XYZ Corporation as of December 31, 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: Paragraph .07 of AU section 504]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a nonissuer, this example is not appropriate. See sections 2610 and 2620.

.04 Disclaimer—Regulatory (Statutory) Basis Statements

(When an accountant is associated with unaudited financial statements of a public entity prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles)

Addressee:

The accompanying statement of admitted assets, liabilities, and surplus—statutory basis of XYZ Insurance Company as of December 31, 20XX, and the related statements of income—statutory basis, cash flows—statutory basis, and changes in surplus—statutory basis for the year then ended were not audited by us and, accordingly, we do not express an opinion on them.

[*Signature*]

[*Date*]

[Source: Derived from paragraph .07 of AU section 504]

Notes: A note to the financial statements should describe how the basis of presentation differs from generally accepted accounting principles, but the monetary effect of such differences need not be stated.

The disclaimer may accompany the unaudited financial statements or it may be placed directly on them. In addition, each page of the financial statements should be clearly and conspicuously marked as unaudited.

If the unaudited financial statements are those of a nonissuer, this example is not appropriate. See sections 2610 and 2620.

[*The next page is 9621.*]

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AAM Section 9280

Lack of Independence

.01 Disclaimer

Addressee:

We are not independent with respect to XYZ Company, and the accompanying balance sheet as of December 31, 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: Paragraph .10 of AU section 504, *Association With Financial Statements* (AICPA, *Professional Standards*)]

Notes: When an accountant is not independent, any procedures he or she might perform would not be in accordance with generally accepted auditing standards and he or she would be precluded from expressing an opinion on the financial statements. Accordingly, he or she should disclaim an opinion with respect to the financial statements and state specifically that he or she is not independent. The accountant should not include in his or her disclaimer the reasons for the lack of independence or any description of the procedures he or she has performed; including such matters might confuse readers concerning the importance of the lack of independence.

If the financial statements are those of a nonissuer, the accountant must consider the guidance in Statements on Standards for Accounting and Review Services.

[*The next page is 9671.*]

AAM Section 9300

Review of Interim Financial Information

.01 Independent Accountant's Report[1]

Independent Accountant's Report

Addressee:

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This interim financial information 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 and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information for it to be in conformity with [*identify the applicable financial reporting framework; for example, accounting principles generally accepted in the United States of America*].

[*Signature*]

[*Date*]

[Source: Paragraph .38 of AU section 722, *Interim Financial Information* (AICPA, *Professional Standards*)]

Note: AU section 722 establishes standards and provides guidance on the nature, timing, and extent of the procedures to be performed by an independent accountant when conducting a review of interim financial information, as that term is defined in paragraph .02 of AU section 722.

[1] If interim financial information of a prior period is presented with that of the current period and the accountant has conducted a review of that information, the accountant should report on his or her review of the prior period. An example of the first sentence of such a report follows: "We have reviewed ... of ABC Company and consolidated subsidiaries as of September 30, 20X1 and 20X2, and for the three-month and nine-month periods then ended ...."

.02 Independent Accountant's Report—Reference Made to Another Accountant's Review Report on the Interim Financial Information of a Significant Component of a Reporting Entity[2]

Independent Accountant's Report

Addressee:

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This interim financial information is the responsibility of the company's management.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

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 and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information taken as a whole. Accordingly, we do not express such an opinion.

Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information for it to be in conformity with [*identify the applicable financial reporting framework; for example, accounting principles generally accepted in the United States of America*].

[*Signature*]

[*Date*]

[Source: Paragraph .40 of AU section 722]

Note: AU section 722 establishes standards and provides guidance on the nature, timing, and extent of the procedures to be performed by an independent accountant when conducting a review of interim financial information, as that term is defined in paragraph .02 of AU section 722.

[*The next page is 9701.*]

[2] See AU section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*).

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AAM Section 9400

Accountants' Reports on Condensed Financial Statements and Selected Financial Data

.01 Unqualified Opinion on Condensed Financial Statements

Independent Auditor's Report

Addressee:

We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[*Signature*]

[*Date*]

[Source: Paragraph .06 of AU section 552, *Reporting on Condensed Financial Statements and Selected Financial Data* (AICPA, *Professional Standards*)]

.02 Adverse Opinion on Condensed Financial Statements Due to Inadequate Disclosure

Independent Auditor's Report

Addressee:

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America.

In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended.

[*Signature*]

[*Date*]

Note: The above report is used when expressing an adverse opinion on condensed financial statements with inadequate disclosures that are included in a client-prepared document and the client is a nonissuer.

[Source: Footnote 6 in paragraph .07 of AU section 552]

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.03 Review Report on Condensed Financial Statements

Independent Accountant's Report

Addressee:

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. This condensed financial information is the responsibility of the company's management.

We conducted our reviews 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 and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial information referred to above for them to be in conformity with [*identify the applicable financial reporting framework; for example, accounting principles generally accepted in the United States of America*].

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

[*Signature*]

[*Date*]

[Source: Paragraph .39 of AU section 722, *Interim Financial Information* (AICPA, *Professional Standards*]

Note: This is an illustrative review report on a condensed balance sheet as of March 31, 20X1, and the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q.

[*The next page is 9801.*]

AAM Section 9600

Reports on Employee Benefit Plans

Practice Tip

Audits of 11-K Filers—Performance and Reporting Requirements

SEC Requirements

The Securities and Exchange Commission (SEC) requires employee stock purchase, savings and similar plans with interests that constitute securities registered under the Securities Act of 1933 to file Form 11-K pursuant to Section 15(d) of the Securities Exchange Act of 1934. Reports on Form 11-K must be filed with the SEC within 90 days after the end of the fiscal year of the plan, provided that plans subject to the Employee Retirement Income Security Act of 1974 (ERISA) file the plan financial statements within 180 days after the plan's fiscal year end.

Applicable Audit Standards

Plans that are required to file Form 11-Ks are deemed to be *issuers* under the Sarbanes-Oxley Act and must submit to the SEC an audit in accordance with the auditing and related professional practice standards promulgated by the Public Company Accounting Oversight Board (PCAOB).

Performance and Reporting Requirements

Based on AICPA staff discussions with the SEC and PCAOB staff to seek clarification of the performance and reporting requirements for audits of 11-K filers, firms will need to conduct their audits of these 11-K plans in accordance with two sets of standards and prepare two separate audit reports; an audit report referencing PCAOB standards for Form 11-K filings with the SEC and a separate audit report referencing generally accepted auditing standards (GAAS) for Department of Labor (DOL) filings. The PCAOB and SEC staff believe that an opinion issued in accordance with PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), does not allow a reference to GAAS, hence a "dual" standard report is not appropriate and will not be accepted by the SEC.

Any questions regarding performance and reporting requirements of audits of financial statements of Form 11-K filers should be directed to the SEC Division of Corporation Finance, Office of the Chief Accountant at (202) 942-2960.

.01 Unqualified Opinion—Defined Benefit Plan Assuming End-of-Year Benefit Information Date

Independent Auditor's Report

Addressee:

We have audited the accompanying statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 20X2, and 20X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion*.][*] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 20X2, and 20X1, and the changes in its financial status for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.[1]

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of January 1, 2011, paragraph 13.04]

> ***Note:*** Section 2520.103-1 of Title 29 U.S. Code of Federal Regulations (CFR) Part 2520.C requires the accountant's report to be dated, manually signed, indicate the city and state where issued and identify the financial statements and schedules covered by the report.

[*] This optional language may be added to the auditor's standard report to clarify that an audit performed in accordance with GAAS does not require the same level of testing and reporting on internal control over financial reporting as an audit of an issuer when Section 404(b) of the act is applicable. If this optional language is added then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

See Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88), issued in June 2004.

[1] Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 960, *Plan Accounting—Defined Benefit Pension Plans*, left unresolved the question of whether accumulated plan benefit information represents a liability of a defined benefit pension plan. Accordingly, because the financial statements of a defined benefit pension plan do not present information on accumulated plan benefits as a liability of the plan, and because they do not present an account comparable to the owners' equity of other types of entities, the auditor's opinion in the illustrative reports does not refer to the presentation of the financial position of the plan. The terms *financial status* and *changes in financial status*, as used here, refer to the presentation of information regarding net assets available for plan benefits and changes therein and information regarding accumulated plan benefits and changes therein as specified in FASB ASC 960.

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.02 Unqualified Opinion—Defined Benefit Plan Assuming Beginning-of-Year Benefit Information Date

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2, and 20X1, and the related statements of changes in net assets available for benefits for the years then ended and the statement of accumulated plan benefits as of December 31, 20X1, and the related statement of changes in accumulated plan benefits for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion*.][*] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, information regarding the Plan's net assets available for benefits as of December 31, 20X2, and changes therein for the year then ended and its financial status as of December 31, 20X1, and changes therein for the year then ended in conformity with accounting principles generally accepted in the United States of America.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.05]

[*] See footnote * in paragraph .01.

.03 Unqualified Opinion—Defined Contribution Profit-Sharing Plan

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of ABC Company Profit-Sharing Plan as of December 31, 20X2, and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion*.][*] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X2, and 20X1, and the changes in net assets available for benefits for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.06]

[*] See footnote * in paragraph .01.

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.04 Unqualified Opinion—Employee Health and Welfare Benefit Plans

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits and of plan benefit obligations of Allied Industries Benefit Plan as of December 31, 20X2, and 20X1, and the related statements of changes in net assets available for benefits and of changes in benefits obligations for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion*.][*] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial status of the Plan as of December 31, 20X2, and 20X1, and the changes in its financial status for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.07]

[*] See footnote in paragraph .01.

.05 Unqualified Opinion—Supplemental Schedules Required by ERISA and DOL Regulations

Independent Auditor's Report

[*Addressee*]

Our audits were performed for the purpose of forming an opinion on the basic financial statements taken as a whole. The supplemental schedules of [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, 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 paragraphs .07–.08 and .18.

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.06 Unqualified Opinion—Defined Benefit Pension Plan Prepared on the Modified Cash Basis

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits (modified cash basis) of XYZ Pension Plan as of December 31, 20X2, and 20X1, and the related statement of changes in net assets available for benefits (modified cash basis) for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion*.][*] 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 GAAP.

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of XYZ Pension Plan as of December 31, 20X2, and 20X1, and the changes in net assets available for benefits for the year ended December 20X2, on the basis of accounting described in Note X.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules (modified cash basis) of [*identify titles of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.22]

[*] See footnote * in paragraph .01.

Note: When reporting on financial statements prepared in conformity with a basis of accounting other than generally accepted accounting principles (GAAP), the auditor should consider whether the financial statements and notes thereto include all informative disclosures that are appropriate for the basis of accounting used. Interpretation No. 14, "Evaluating the Adequacy of Disclosure and Presentation in Financial Statements Prepared in Conformity With an Other Comprehensive Basis of Accounting (OCBOA)," of AU section 623, *Special Reports* (AICPA, *Professional Standards*, AU sec. 9623 par. .90–.95), states that if cash, modified cash, or income tax basis financial statements contain elements, accounts, or items for which GAAP would require disclosure, the statements should either provide the relevant disclosure that would be required for those items in a GAAP presentation or provide information that communicates the substance of that disclosure. That may result in substituting qualitative information for some of the quantitative information required for GAAP presentations. Regardless of the basis of accounting used (GAAP or OCBOA), accumulated plan benefits disclosures should be made. If such disclosures are not made, the auditor should comment in his or her report on the lack of such disclosures and should express a qualified or adverse opinion on the financial statements.

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.23]

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.07 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations

Following are examples of paragraphs added to the auditor's report when the auditor modifies his or her report on the supplemental schedules because of omitted information or an omitted schedule which is required under DOL regulations:

Independent Auditor's Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report.* See paragraphs .01–.03 in this section.]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2 that accompanies the Plan's financial statements does not disclose the historical cost of certain nonparticipant directed plan assets held by the Plan trustee [or custodian]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

or

The Plan has not presented the supplemental Schedule H, line 4j—Schedule of Reportable Transactions for the year ended December 31, 20X2. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.16]

.08 Qualified Opinion—Omitted or Incomplete Schedule or Material Inconsistency

The following are examples of paragraphs that have been added to the auditor's report when the auditor qualifies his or her opinion on the supplemental schedules because a schedule, or information thereon, was omitted (when the schedules are not covered by a trustee's certification as to completeness and accuracy), or because information in a required schedule is materially inconsistent with the financial statements.

Independent Auditor's Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report.* See paragraphs .01–.03 in this section.]

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2, that accompanies the Plan's financial statements does not disclose that the Plan had loans to participants, which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.16]

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.09 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been added to the auditor's report on the plan's financial statements when the auditor qualifies his or her opinion on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditor's Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report.* See paragraphs .01–.03 in this section.][2]

The supplemental Schedule G, Part III—Nonexempt Transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.17]

[2] If a material party in interest transaction that is not disclosed in the supplemental 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 paragraph .12 in this section.

.10 Adverse Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been added to the auditor's report on the plan's financial statements when the auditor decides that an adverse opinion should be expressed on the supplemental schedules because disclosure of a material prohibited transaction with a party in interest is omitted.

Independent Auditor's Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report*. See paragraphs .01–.03 in this section.][3]

Schedule G, Part III—Nonexempt Transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, because of the omission of the information discussed in the preceding paragraph are not fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of January 1, 2011, paragraph 13.17]

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[3] See footnote 2.

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.11 Modified Report—Disclosure of Immaterial Prohibited Transaction With Party in Interest Omitted

The following are examples of paragraphs that have been added to the auditor's report on the plan's financial statements when the auditor decides to modify his or her report on the supplemental schedules because disclosure of a prohibited transaction with a party in interest that is not material to the financial statements has been omitted.

Independent Auditor's Report

[*Addressee*]

[*Same first, second, and third paragraphs as the standard report.* See paragraphs .01–.03 in this section.]

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Schedule G, Part III—Nonexempt Transactions that accompanies the plan's financial statements does not disclose that the Plan [*describe prohibited transaction*]. Disclosure of this information, which is not considered material to the financial statements taken as a whole, is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.17]

.12 Qualified Opinion—Disclosure of Material Prohibited Transaction With Party in Interest Omitted—Related-Party Transaction

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statement of net assets available for benefits of XYZ Company Profit-Sharing Plan as of December 31, 20X1 and 20X0, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X1. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

The Plan's financial statements do not disclose that the Plan [*describe related-party transaction*]. Disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X1, and 20X0, and the changes in net assets available for benefits for the year ended December 31, 20X1, in conformity with accounting principles generally accepted in the United States of America.

Schedule G, Part III—Nonexempt Transactions that accompanies the plan's financial statements does not disclose that the plan [*describe prohibited transaction*]. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audits of the basic financial statements and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.18]

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.13 Limited-Scope Audits Under DOL Regulations

Independent Auditor's Report

[*Addressee*]

We were engaged to audit the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2, and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the supplemental schedules of (1) Schedule H, line 4i-Schedule of Assets (Held At End of Year), and (2) Schedule H, line 4j-Schedule of Reportable Transactions as of or for the year ended December 31, 20X2. These financial statements and supplemental schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of December 31, 20X2, and 20X1 and for the year ended December 31, 20X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules taken as a whole. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee or custodian, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.26]

Note: If the plan's financial statements are prepared on the cash basis or a modified cash basis of accounting, the auditor's report should also include a paragraph stating the basis of presentation and that cash basis is a comprehensive basis of accounting other than GAAP (see paragraph 13.21–.22 of Audit and Accounting Guide *Employee Benefit Plans,* for wording of such a paragraph).

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.26 footnote 6]

.14 Limited-Scope Audit in Prior Year

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2, and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the statements of accumulated plan benefits as of December 31, 20X2, and 20X1, and the related statement of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, investment assets held by ABC Bank, the trustee (or custodian) of the Plan, and transactions in those assets were excluded from the scope of our audit of the Plan's 20X1 financial statements, except for comparing the information provided by the trustee (or custodian), which is summarized in Note X, with the related information included in the financial statements.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the Plan's financial statements as of December 31, 20X1. The form and content of the information included in the 20X1 financial statements, other than that derived from the information certified by the trustee (or custodian), have been audited by us and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

In our opinion, the financial statements, referred to above, of XYZ Pension Plan as of December 31, 20X2, and for the year then ended present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X2, and changes in its financial status for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit of the Plan's financial statements as of and for the year ended December 31, 20X2, was made for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. The supplemental schedules have been subjected to the auditing procedures applied in the audit of the basic financial statements for the year ended December 31, 20X2, and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.28]

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.15 Limited-Scope Audit in Current Year

Independent Auditor's Report

[*Addressee*]

We were engaged to audit the accompanying statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets Held (At End of Year), (2) Schedule H, line 4j—Schedule of Reportable Transactions as of or for the year ended December 31, 20X2. These financial statements and supplemental schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in Note X, which was certified by ABC Bank, the trustee (or custodian) of the Plan, except for comparing the information with the related information included in the 20X2 financial statements and the supplemental schedules. We have been informed by the plan administrator that the trustee (or custodian) holds the Plan's investment assets and executes investment transactions. The plan administrator has obtained a certification from the trustee (or custodian) as of and for the year ended December 31, 20X2, that the information provided to the plan administrator by the trustee (or custodian) is complete and accurate.

Because of the significance of the information in the Plan's 20X2 financial statements that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules as of or for the year ended December 31, 20X2. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the information certified by the trustee (or custodian), have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

We have audited the statement of net assets available for benefits of XYZ Pension Plan as of December 31, 20X1, and in our report dated May 20, 20X2, we expressed our opinion that such financial statement presents fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X1, in conformity with accounting principles generally accepted in the United States of America.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.29]

.16 Initial Limited-Scope Audit in Current Year, Prior Year Limited-Scope Audit Performed by Other Auditors

Report of Independent Certified Public Accountants

[*Addressee*]

We were engaged to audit the accompanying statement of net assets available for benefits of ABC Company Profit-Sharing Plan (the Plan) as of December 31, 20X2, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2, and the supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2. These financial statements and supplemental schedule are the responsibility of the Plan's management. The financial statements of the plan as of December 31, 20X1, were audited by other auditors. As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 (ERISA), the Plan administrator instructed the other auditors not to perform and they did not perform, any auditing procedures with respect to the information certified by the Trustee. Their report, dated May 20, 20X2, indicated that (*a*) because of the significance of the information that they did not audit, they were unable to, and did not, express an opinion on the financial statements taken as a whole and (*b*) the form and content of the information included in the financial statements other than that derived from the information certified by the Trustee, were presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under ERISA.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the Plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the information summarized in note E, which was certified by Bank & Trust Company, the trustee of the Plan, except for comparing such information with the related information included in the 20X2 financial statements and supplemental schedule. We have been informed by the Plan administrator that the trustee holds the Plan's investment assets and executes investment transactions. The Plan administrator has obtained a certification from the trustee as of and for the year ended December 31, 20X2, that the information provided to the Plan administrator by the trustee is complete and accurate.

Because of the significance of the information in the Plan's 20X2 financial statements and supplemental schedule that we did not audit, we are unable to, and do not, express an opinion on the accompanying 20X2 financial statements and supplemental schedule taken as a whole. The form and content of the information included in the 20X2 financial statements and supplemental schedule, other than that derived from the information certified by the trustee, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of January 1, 2011, paragraph 13.30]

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.17 Limited Scope Audit—Change in Trustee

Report of Independent Certified Public Accountants

[*Addressee*]

We were engaged to audit the accompanying statements of net assets available for benefits and of accumulated plan benefits of XYZ Pension Plan as of December 31, 20X2, and 20X1, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2, and the supplemental schedules of (1) Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2, and (2) Schedule H, line 4j—Schedule of Reportable Transactions for the year ended December 31, 20X2. These financial statements and schedules are the responsibility of the Plan's management.

As permitted by 29 CFR 2520.103-8 of the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974, the plan administrator instructed us not to perform, and we did not perform, any auditing procedures with respect to the investment information summarized in Note X, which was certified by the ABC Bank and XYZ Trust Company, the trustees of the Plan, except for comparing such information with the related information included in the financial statements and supplemental schedules. We have been informed by the plan administrator that XYZ Trust Company held the Plan's investment assets and executed investment transactions from July 1, 20X2, to December 31, 20X2, and that ABC Bank held the Plan's investment assets and executed investment transactions as of December 31, 20X1, and for the period January 1, 20X1, to June 30, 20X2. The plan administrator has obtained certifications from the trustees as of and for the years ended December 31, 20X2, and 20X1, that the information provided to the plan administrator by the trustees is complete and accurate.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and supplemental schedules taken as a whole. The form and content of the information included in the financial statements and supplemental schedules, other than that derived from the investment information certified by the trustees, have been audited by us in accordance with auditing standards generally accepted in the United States and, in our opinion, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.31]

.18 Audit of Multiemployer Defined Benefit Pension Plan With Scope Limitation

Independent Auditor's Report

[*Addressee*]

We were engaged to audit the statements of [*identify title of schedules and period covered*] of XYZ Multiemployer Pension Plan as of December 31, 20X2, and 20X1, and for the years then ended. These financial statements are the responsibility of the Plan's management.

The Plan's records and procedures are not adequate to assure the completeness of participants' data on which contributions and benefit payments are determined, and the Board of Trustees did not engage us to perform, and we did not perform, any other auditing procedures with respect to participants' data maintained by the sponsor companies or individual participants.

Because of the significance of the information that we did not audit, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.32]

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.19 Modified Report—Omitted Information or Omitted Schedule Required Under DOL Regulations in a Limited Scope Engagement

Independent Auditor's Report

[*Addressee*]

[*Same first and second paragraphs as the limited-scope report.* See paragraph .13 in this section.]

The supplemental Schedule H, line 4i—Schedule of Assets (Held at End of Year) as of December 31, 20X2, that accompanies the Plan's financial statements does not disclose that the Plan has loans to participants, which are considered assets held for investment purposes. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

Because of the significance of the information that we did not audit, we are unable to, and do not, express an opinion on the accompanying financial statements and schedules taken as a whole. The form and content of the information included in the financial statements and schedules, other than that derived from the information certified by the trustee, have been audited by us in accordance with auditing standards generally accepted in the United States of America and, in our opinion, except for the omission of the information discussed in the preceding paragraph, are presented in compliance with the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

or

[*Addressee*]

[*Same first, second, and third paragraphs as the limited-scope report.*]

The Plan has not presented the supplemental Schedule H, line 4j—Schedule of Reportable Transactions for the year ended December 31, 20X2. Disclosure of this information is required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974.

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[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.16]

.20 Trust Established Under an Employee Benefit Plan

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statement of net assets of ABC Pension Trust as of December 31, 20X2, and the related statement of changes in net assets and trust balance for the year then ended. These financial statements are the responsibility of the Trust's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets of ABC Pension Trust as of December 31, 20X2, and the changes in its net assets and trust balance for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The accompanying statements are those of ABC Pension Trust, which is established under XYZ Pension Plan; the statements do not purport to present the financial status of XYZ Pension Plan. The statements do not contain certain information on accumulated plan benefits and other disclosures necessary for a fair presentation of the financial status of XYZ Pension Plan in conformity with accounting principles generally accepted in the United States of America. Furthermore, these statements do not purport to satisfy the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974 relating to the financial statements of employee benefit plans.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of January 1, 2011, paragraph 13.33]

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.21 Defined Benefit Plan Assuming Inadequate Procedures to Value Investments

Independent Auditor's Report

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of XYZ Pension Plan as of December 31, 20X2, and 20X1, and of accumulated Plan benefits as of December 31, 20X2, and the related statements of changes in net assets available for benefits and of changes in accumulated plan benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion*.][*] An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note X, investments amounting to $______ (__ percent of net assets available for benefits) as of December 31, 20X2, have been valued at estimated fair value as determined by the Board of Trustees. We have reviewed the procedures applied by the trustees in valuing the securities and have inspected the underlying documentation. In our opinion, those procedures are not adequate to determine the fair value of the investments in conformity with accounting principles generally accepted in the United States of America. The effect on the financial statements and supplemental schedules of not applying adequate procedures to determine the fair value of the securities is not determinable.

In our opinion, except for the effects of the procedures used by the Board of Trustees to determine the valuation of investments as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial status of XYZ Pension Plan as of December 31, 20X2, and information regarding the Plan's net assets available for benefits as of December 31, 20X1, and the changes in its financial status for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

Our audits were performed for the purpose of forming an opinion on the financial statements taken as a whole. The supplemental schedules of [*identify title of schedules and period covered*] are presented for the purpose of additional analysis and are not a required part of the basic financial statements, but are supplementary information required by the Department of Labor's Rules and Regulations for Reporting and Disclosure under the Employee Retirement Income Security Act of 1974. These supplemental schedules are the responsibility of the Plan's management. 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, 20X2; and in our opinion, except for the effects of the valuation of investments, as described above, the additional information is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans*, updated as of January 1, 2011, paragraph 13.38]

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[*] See footnote * in paragraph .01.

.22 Form 11-K Filing

Report of Independent Registered Public Accounting Firm

[*Addressee*]

We have audited the accompanying statements of net assets available for benefits of the ABC 401(k) plan (the Plan) as of December 31, 20X2, and 20X1, and the related statement of changes in net assets available for benefits for the year ended December 31, 20X2. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets available for benefits of the Plan as of December 31, 20X2, and 20X1, and the changes in net assets available for benefits for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

____

[*Signature of Firm*]

[*City and State*]

[*Date*]

[Source: AICPA Audit and Accounting Guide *Employee Benefit Plans,* updated as of January 1, 2011, paragraph 13.19]

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Note: Reporting Considerations for Nonaccelerated Filer Audit Reports. In an audit of a nonaccelerated filer that has determined it is not required to obtain, nor did it request the auditor to perform, an audit of internal control over financial reporting (under Section 404(b) of the Sarbanes-Oxley Act of 2002 and Item 308(b) of SEC Regulation S-K), firms may wish to consider expanding their audit report to include a statement that the purpose and extent of the auditor's consideration of internal control over financial reporting were to determine that the nature, timing, and extent of tests to be performed are appropriate in the circumstances but were not sufficient to express an opinion on the effectiveness of internal control over financial reporting. Firms are not required to expand their audit report to include this statement. However, the SEC staff has indicated that if a firm chooses to expand its report to clarify this point, the language in Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), provides appropriate language to consider in an audit conducted in accordance with PCAOB standards. Accordingly, the scope section of the auditor's report might be modified as follows:

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. ***The Plan is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Plan's internal control over financial reporting. Accordingly, we express no such opinion.*** An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

[This information is from the Center for Audit Quality (CAQ)—CAQ Alert #2007-66—December 19, 2007.]

[*The next page is 9851.*]

AAM Section 9650

Reports on Financial Statements of Brokers and Dealers in Securities

.01 Unqualified Opinion on Financial Statements and Supplementary Schedules Required by the SEC

Independent Auditor's Report

Board of Directors
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying [*consolidated*] statement of financial condition of Standard Stockbrokerage Co., Inc., [*and Subsidiaries*] (the Company) as of December 31, 20X1, and the related [*consolidated*] statements of income, changes in stockholders' equity, changes in liabilities subordinated to claims of general creditors, and cash flows for the year then ended that you are filing pursuant to Rule 17a-5 under the Securities Exchange Act of 1934. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[1] Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. [*Optional: An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion*.][2] An audit includes examining, on a test basis, 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

[1] For audits conducted in accordance with Public Company Accounting Oversight Board (PCAOB) standards, PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), replaces this sentence with the following sentence: "We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States)." On May 14, 2004, the Securities and Exchange Commission (SEC) issued an interpretive release to help with the implementation of PCAOB Auditing Standard No. 1. See Release No. 33-8422 for more information. The release specifies that effective May 14, 2004, references in SEC rules and staff guidance and in the federal securities laws to generally accepted auditing standards (GAAS) or to specific standards under GAAS, as they relate to issuers, should be understood to mean the standards of the PCAOB, plus any applicable rules of the SEC. The guidance in this release is applicable only to auditors' engagements that are governed by PCAOB rules. The PCAOB, for example, has not established particular auditing standards for nonissuer broker-dealers or investment advisers. This release is not applicable to such engagements and related filings.

The staff of the PCAOB published a series of questions and answers on PCAOB Auditing Standard No. 1. See the PCAOB website at www.pcaob.org for more information.

In June 2004, the Auditing Standards Board (ASB) issued Interpretation No. 18, "Reference to PCAOB Standards in an Audit Report of a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .89–.92), which provides reporting guidance for audits of nonissuers. Interpretation No. 18 provides guidance on the appropriate referencing of PCAOB auditing standards in audit reports when an auditor is engaged to perform the audit in accordance with both GAAS and PCAOB auditing standards. The ASB also is revising AU section 508 in light of the International Auditing and Assurance Standards Board's recently exposed International Standard on Auditing *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements* and PCAOB Auditing Standard No. 1. See the AICPA website at www.aicpa.org/Research/Standards/AuditAttest/Pages/audit%20and%20attest%20standards.aspx for more information.

[2] This optional wording may be added in accordance with Interpretation No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88), which provides reporting guidance for audits of nonissuers. Interpretation No. 17 addresses how auditors may expand their independent audit report to explain that their consideration of internal control was sufficient to provide the auditor sufficient understanding to plan the audit and determine the nature, timing and extent of tests to be performed, but was not sufficient to express an opinion on the effectiveness of the internal control. If this optional language is added, then the remainder of the paragraph should read as follows:

> An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.[3]

In our opinion, the [*consolidated*] financial statements referred to above present fairly, in all material respects, the financial position of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of December 31, 20X1, and the results of its [*their*] operations and its [*their*] cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm
New York, New York
February 15, 20X2[4]

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities*, updated as of July 1, 2010, appendix A]

Notes: SEC Regulation S-X Section 210.2-02 (17 CFR 210.2–.02) requires the accountant's report to be dated, signed manually, indicate the city and state where issued, and identify without detailed enumeration the financial statements covered by the report.

Paragraphs .18–.19 of section 9250 contain illustrative reports on internal control required by SEC Rule 17a-5.

[3] See paragraphs 3.113–.119 of Audit and Accounting Guide *Brokers and Dealers in Securities* for information on obtaining confidential treatment of the financial statements from the SEC and Commodity Futures Trading Commission.

[4] Paragraph .23 of AU section 339, *Audit Documentation* (AICPA, *Professional Standards*), states that the auditor's report should be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. Among other things, sufficient appropriate audit evidence includes evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that it has taken responsibility for them.

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.02 Separate Report on Supplementary Schedules

Independent Auditor's Report on Supplementary Information Required by Rule 17a-5 of the Securities and Exchange Commission

Board of Directors
Standard Stockbrokerage Co., Inc.:

We have audited the accompanying [*consolidated*] financial statements of Standard Stockbrokerage Co., Inc. [*and Subsidiaries*] as of and for the year ended December 31, 20X1, and have issued our report thereon dated February 15, 20X2. Our audit was conducted for the purpose of forming an opinion on the basic financial statements taken as a whole. The information contained in Schedules I, II, III, and IV is presented for purposes of additional analysis and is not a required part of the basic financial statements, but is supplementary information required by Rule 17a-5 under the Securities Exchange Act of 1934. Such information has been subjected to the auditing procedures applied in the audit of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the basic financial statements taken as a whole.

Accounting Firm
New York, New York
February 15, 20X2

[Source: AICPA Audit and Accounting Guide *Brokers and Dealers in Securities,* updated as of July 1, 2010, appendix B]

Note: This paragraph can be shown separately in the auditor-submitted document or as a separate paragraph, after the opinion paragraph, of the auditor's standard report.

[*The next page is 9901.*]

AAM Section 9700

Reports for Investment Companies

.01 Unqualified Opinion on the Financial Statements of a Registered Investment Company

Report of Independent Registered Public Accounting Firm

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company (the Company), including the schedule of investments, as of December 31, 20X8, and the related statements of operations and cash flows[1] for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended.[2] These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 20X8, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 20X8, the results of its operations and its cash flows[3] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

Independent Auditor
Anytown, USA
January 21, 20X9

[Source: AICPA Audit and Accounting Guide *Investment Companies*, updated as of May 1, 2011, paragraph 11.11]

[1] Financial Accounting Standards Board *Accounting Standards Codification* 230-10-15-4 exempts highly liquid companies that meet specified conditions from the requirements to provide a statement of cash flows. See chapter 7, "Financial Statements of Investment Companies," of Audit and Accounting Guide *Investment Companies* for further discussion.

[2] In accordance with Item 13 of Form N1–A, in an open-end fund's registration statement, an auditor must opine on all five years of financial highlights required to be presented in the open-end fund's prospectus, or, if shorter, the period of the fund's operations.

[3] See footnote 1.

Note: The reference to "and brokers" in the fourth sentence of the scope paragraph is not normally required if the investment company's financial statements do not show an amount payable for securities purchased. When broker confirmations are not received and alternative procedures are performed, the sentence may be modified to read "and brokers or by other appropriate auditing procedures where replies from brokers were not received." Also, if securities were physically inspected or subject to other extended procedures for purposes of the audit, the report should be modified to state that those procedures were performed.

[Source: AICPA Audit and Accounting Guide *Investment Companies*, updated as of May 1, 2011, paragraph 11.12]

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.02 Unqualified Opinion on the Financial Statements for a Multicolumnar Presentation of the Portfolios Constituting the Series[4]

Report of Independent Registered Public Accounting Firm

Addressee:

We have audited the statements of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company (the Company) comprising the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios as of December 31, 20X8, and the related statements of operations and cash flows,[5] for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

[*Same second paragraph as in the report illustrated in paragraph .01.*]

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of each of the portfolios constituting the XYZ Series Investment Company, as of December 31, 20X8, the results of their operations and cash flows[6] for the year then ended, the changes in their net assets for each of the two years in the period then ended, and their financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

Independent Auditor
Anytown, USA
January 21, 20X9

[Source: AICPA Audit and Accounting Guide *Investment Companies*, updated as of May 1, 2011, paragraph 11.15]

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[4] This form of report is prescribed by paragraph .08 of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*). Registered public accounting firms must comply with the standards of the Public Company Accounting Oversight Board (PCAOB) in connection with the preparation or issuance of any audit report on the financial statements of an *issuer*, as discussed in paragraph 11.01 of Audit and Accounting Guide *Investment Companies*. Readers should understand the provisions of the Sarbanes-Oxley Act, the Securities and Exchange Commission regulations implementing the Sarbanes-Oxley Act, and the rules and standards of the PCAOB, as applicable to their circumstances, to determine if the standards of the PCAOB should be applied. Readers should consult the standards of the PCAOB, and related interpretive guidance, when preparing or issuing any audit report on the financial statements of an issuer in accordance with the standards of the PCAOB.

[5] See footnote 1.

[6] See footnote 1.

.03 Unqualified Opinion on the Financial Statements Presenting One of the Portfolios or Entities Constituting the Series[7]

Report of Independent Registered Public Accounting Firm

Addressee:

We have audited the accompanying statement of assets and liabilities, including the schedule of investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company [the Company]) as of December 31, 20X8, and the related statements of operations and cash flows[8] 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 financial highlights for each of the five years in the period then ended. These financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial highlights based on our audits.

[*Same second paragraph as in the report illustrated in paragraph .01*.]

In our opinion, the financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 20X8, and the results of its operations and its cash flows[9] for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the financial highlights for each of the five years in the period then ended, in conformity with accounting principles generally accepted in the United States of America.

Independent Auditor
Anytown, USA
January 21, 20X9

[Source: AICPA Audit and Accounting Guide *Investment Companies,* updated as of May 1, 2011, paragraph 11.16]

[7] See footnote 1.
[8] See footnote 1.
[9] See footnote 1.

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.04 Unqualified Opinion on the Financial Statements of a Nonregistered Investment Company[10]

Independent Auditor's Report

Addressee:

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company (the Company), including the schedule of investments, as of December 31, 20X8, and the related statements of operations, cash flows[11] and changes in net assets for the year then ended.[12] These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America.[13] 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 Investment Company as of December 31, 20X8, the results of its operations, its cash flows[14] and changes in its net assets for the year then ended, in conformity with accounting principles generally accepted in the United States of America.[15]

Independent Auditor
Anytown, USA
February 21, 20X9

[Source: AICPA Audit and Accounting Guide *Investment Companies,* updated as of May 1, 2011, paragraph 11.02]

[*The next page is 10,001.*]

[10] See footnote 1.

[11] See footnote 1.

[12] If the financial highlights are presented in a separate schedule (as opposed to in a footnote), the schedule of financial highlights should be mentioned along with the financial statements throughout the independent auditor's report.

[13] AU section 508 states that a basic element of the auditor's report is a statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards. Interpretation No. 14, "Reporting on Audits Conducted in Accordance With Auditing Standards Generally Accepted in the United States of America and in Accordance With International Standards on Auditing," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .56–.59) states that if the audit also was conducted in accordance with the International Standards on Auditing in their entirety, the auditor may so indicate in the auditor's report. This can be done by modifying this sentence as follows (new language is shown in italics):

> We conducted our audit in accordance with auditing standards generally accepted in the United States of America *and in accordance with International Standards on Auditing*.

[14] See footnote 1.

[15] Interpretation No. 19, "Financial Statements Prepared in Conformity With International Financial Reporting Standards as Issued by the International Accounting Standards Board," of AU section 508 (AICPA, *Professional Standards*, AU sec. 9508 par. .93–.97), states that the auditor may report on general purpose financial statements presented in conformity with International Financial Reporting Standards (IFRSs) as issued by the International Accounting Standards Board. In that scenario, in the auditor's report, the auditor would refer to IFRSs rather than U.S. generally accepted accounting principles. An example opinion paragraph would be (new language is shown in italics):

> In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 20X8, the results of its operations, its cash flows, and changes in its net assets for the year then ended, in conformity with *International Financial Reporting Standards as issued by the International Accounting Standards Board*.

AAM Section 10,000
Quality Control

These sample quality control documents are presented for illustrative purposes only. They are intended as an aid for users of this manual who may want points of departure when establishing their own quality control policies and procedures. These illustrations are neither all inclusive nor are they prescribed minimums. Auditors and accountants must consider the guidance in professional standards and should rely on their individual professional judgment in determining what may be needed in individual circumstances.

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AAM Section 10,100

Quality Control—General

AICPA Requirements

.01 ET section 57, *Article VI—Scope and Nature of Services* (AICPA, *Professional Standards*), of the AICPA's Code of Professional Conduct states that "members should practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised." A firm must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that the firm or engagement partners issue reports that are appropriate in the circumstances. A system of quality control consists of policies designed to achieve these objectives and the procedures necessary to implement and monitor compliance with those policies.

.02 The AICPA issues Statements on Quality Control Standards (SQCSs) to establish standards and provide guidance to firms on establishing and maintaining a quality control system for their accounting and auditing practices. In October 2007, the AICPA issued SQCS No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A).* SQCS No. 7 was effective as of January 1, 2009, and superseded all extant SQCSs.

.03 Presented in section 10,200 is *Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Revised for the Issuance of Statement on Quality Control Standards No. 7,* A Firm's System of Quality Control. Following the practice aid in section 10,300 are sample quality control forms to aid practitioners in implementing a quality control system.

[*The next page is 10,201.*]

* Resulting from its Clarity Project, the Auditing Standards Board (ASB), in November 2010, issued Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control* (Redrafted) (AICPA, *Professional Standards*, QC sec. 10). SQCS No. 8 does not change or expand the requirements and guidance contained in SQCS No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), in any significant respect.

An executive summary of SQCS No. 8 can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/DownloadableDocuments/RecentlyIssuedSQCSs/SQCS_8_Summary.pdf.

Additional information on the ASB's Clarity Project can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx.

The provisions of SQCS No. 8 are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

AAM Section 10,200

Practice Aid for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Revised for the Issuance of Statement on Quality Control Standards No. 7, A Firm's System of Quality Control*

NOTICE TO READERS

This AICPA Audit and Accounting Practice Aid updates *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, which was issued in 2004. This practice aid is intended to help practitioners better understand and apply Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A). That standard is included in appendix A of this practice aid. This version of the practice aid, prepared by the Quality Control Standards Task Force, has been revised to incorporate new policies and procedures that a firm should consider including in its system of quality control to be responsive to the issuance of SQCS No. 7. The policies and procedures presented in this practice aid are illustrative, and firms are encouraged to consider them in designing and maintaining a system of quality control that is appropriate for their accounting and auditing practices. Some of the policies and procedures presented in this practice aid are not required by the SQCSs; however, they represent the views of the task force regarding best practices for a quality control system. Although this practice aid has been reviewed by the AICPA Audit and Attest Standards staff, it has not been approved, disapproved, or otherwise acted upon by any senior technical committee of the AICPA and has no official or authoritative status.

The Sarbanes-Oxley Act of 2002 (Act) created the Public Company Accounting Oversight Board (PCAOB) and charged it with overseeing audits of issuers,[1] as defined by the act. Under the act, the PCAOB's duties include, among other things, establishing auditing, quality control, ethics, independence, and other standards relating to audits of issuers.

This practice aid does not address the quality control requirements of the act, nor does it address the quality control requirements of PCAOB standards that must be followed by auditors of issuers. Auditors of issuers should follow these other standards and make changes to their firm's quality control systems as necessary. Auditors of nonissuers who are engaged to report on audit engagements in accordance with PCAOB auditing standards also must report on those engagements in accordance with generally accepted auditing standards

* Resulting from its Clarity Project, the Auditing Standards Board (ASB), in November 2010, issued Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control* (Redrafted) (AICPA, *Professional Standards*, QC sec. 10). SQCS No. 8 does not change or expand the requirements and guidance contained in SQCS No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), in any significant respect.

An executive summary of SQCS No. 8 can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/DownloadableDocuments/RecentlyIssuedSQCSs/SQCS_8_Summary.pdf.

Additional information on the ASB's Clarity Project can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx.

The provisions of SQCS No. 8 are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

[1] Paragraph 7 of Section 2, "Definitions," of the Sarbanes-Oxley Act of 2002 states, "The term *issuer* means an issuer (as defined in section 3 of the Securities Exchange Act of 1934 [15 U.S.C. 78c]), the securities of which are registered under section 12 of that act [15 U.S.C. 78l], or that is required to file reports under section 15(d) [15 U.S.C. 78o(d)], or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933 [15 U.S.C. 77a et seq.], and that it has not withdrawn."

(GAAS). Interpretations No. 17, "Clarification in the Audit Report of the Extent of Testing of Internal Control Over Financial Reporting in Accordance With Generally Accepted Auditing Standards," and No. 18, "Reference to PCAOB Standards in an Audit Report on a Nonissuer," of AU section 508, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, AU sec. 9508 par. .85–.88 and par. .89–.92, respectively), provide reporting guidance for audits of nonissuers when the auditor is asked to report in accordance with GAAS and PCAOB auditing standards.

Additional information about the PCAOB and the act can be obtained at the PCAOB website at www.pcaobus.org.

Quality Control Standards Task Force (2007)

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Chapter 1: Overview of Statements on Quality Control Standards

1.01 The objectives of a system of quality control are to provide a CPA firm with reasonable assurance[1] that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the circumstances. SQCS No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), was issued by the Auditing Standards Board (ASB) of the AICPA in October 2007 and is effective for a firm's accounting and auditing practice as of January 1, 2009. This standard supersedes all previously issued SQCSs.

1.02 A system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The nature, extent, and formality of a firm's quality control policies and procedures will depend on various factors such as the firm's size; the number and operating characteristics of its offices; the degree of authority allowed to, and the knowledge and experience possessed by, firm personnel; and the nature and complexity of the firm's practice.

Communication of Quality Control Policies and Procedures

1.03 The firm should communicate its quality control policies and procedures to its personnel. Most firms will find it appropriate to communicate their policies and procedures in writing and distribute, or make available electronically, them to all professional personnel.

1.04 Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality
- A requirement for each individual to be familiar with and to comply with these policies and procedures

Effective communication also includes procedures for personnel to communicate their views or concerns on quality control matters to the firm's management.

Elements of a System of Quality Control

1.05 A firm's system of quality control should include policies and procedures that address each of the following elements of quality control identified in SQCS No. 7:

- Leadership responsibilities for quality within the firm (the "tone at the top")
- Relevant ethical requirements
- Acceptance and continuance of client relationships and specific engagements
- Human resources
- Engagement performance
- Monitoring

1.06 The elements of quality control are interrelated. For example, a firm continually assesses client relationships to comply with relevant ethical requirements, including independence, integrity, and objectivity, and policies and procedures related to the acceptance and continuance of client relationships and specific engagements. Similarly, the human resources element of quality control encompasses criteria related to professional development, hiring, advancement, and assignment of firm personnel to engagements, all of which affect policies and procedures related to engagement performance. In addition, policies and procedures

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[1] The term *reasonable assurance*, which is defined as a high, but not absolute, level of assurance, is used because absolute assurance cannot be attained. Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), states, "Any system of quality control has inherent limitations that can reduce its effectiveness."

related to the monitoring element of quality control enable a firm to evaluate whether its policies and procedures for each of the other five elements of quality control are suitably designed and effectively applied.

1.07 If a firm merges, acquires, sells, or otherwise changes a portion of its practice, the surviving firm evaluates and, as necessary, revises, implements, and maintains firm-wide quality control policies and procedures that are appropriate for the changed circumstances.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

1.08 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. The firm should establish and maintain the following policies and procedures to satisfy this objective:

- Require the firm's leadership (managing partner, board of managing partners or CEO, or equivalent) to assume ultimate responsibility for the firm's system of quality control.
- Assign management responsibilities so that commercial considerations do not override the quality of the work performed.
- Assign operational responsibility for the firm's quality control system to personnel who have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.
- Design policies and procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.
- Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

Relevant Ethical Requirements

1.09 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Establishing and maintaining policies such as the following ordinarily would satisfy this objective:

- Require that personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the U.S. Government Accountability Office (GAO), and any other applicable regulators.
- Establish procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.
- Establish procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.
- Require that the firm withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.

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- Require written confirmation, at least annually, of compliance with the firm's policies and procedures on independence from all firm personnel required to be independent by relevant requirements.
- Establish procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of the engagement. This would apply to national firm personnel, foreign firm personnel, and foreign-associated firms.[2]
- Require the rotation of personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.

Acceptance and Continuance of Client Relationships and Specific Engagements

1.10 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

1.11 This objective ordinarily should be satisfied before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client by establishing and maintaining policies such as the following:

- Evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.[3]
- Evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.
- Obtain an understanding, preferably in writing, with the client regarding the services to be performed.
- Establish procedures on withdrawal from an engagement or from both the engagement and the client relationship, including procedures for dealing with information that would have caused the firm to decline an engagement if the information had been available earlier.
- Require documentation of how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.

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[2] A foreign-associated firm is a firm domiciled outside of the United States and its territories that is a member of, correspondent with, or similarly associated with an international firm or international association of firms.

[3] Such considerations would include the risk of providing professional services to significant clients or to other clients for which the practitioner's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a member or a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. Examples of factors to consider in determining the significance of a client to an engagement partner, office, or practice unit include (*a*) the amount of time the partner, office, or practice unit devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner, office, or practice unit is compensated, or (*d*) the effect that losing the client would have on the partner, office, or practice unit.

Human Resources

1.12 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Establishing and maintaining policies such as the following ordinarily would satisfy this objective:

- Recruit and hire personnel of integrity who possess the characteristics that enable them to perform competently.
- Determine capabilities and competencies required for an engagement, especially for the engagement partner, based on the characteristics of the particular client, industry, and kind of service being performed. Specific competencies necessary for an engagement partner are discussed in paragraph 45 of SQCS No. 7.
- Determine the capabilities and competencies possessed by personnel.
- Assign the responsibility for each engagement to an engagement partner.
- Assign personnel based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.
- Have personnel participate in general and industry-specific continuing professional education and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable continuing professional education requirements of the AICPA, state boards of accountancy, and other regulators.
- Select for advancement only those individuals who have the qualifications necessary to fulfill the responsibilities they will be called on to assume.

Engagement Performance

1.13 The objectives of the engagement performance element of quality control are to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed.

1.14 The objectives of the engagement performance element of quality control ordinarily would be satisfied by establishing and maintaining policies such as the following:

- Plan all engagements to meet professional, regulatory, and the firm's requirements.
- Perform work and issue reports and other communications that meet professional, regulatory, and the firm's requirements.
- Require that work performed by other team members be reviewed by qualified engagement team members, which may include the engagement partner, on a timely basis.
- Require the engagement team to complete the assembly of final engagement files on a timely basis.
- Establish procedures to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.
- Require the retention of engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.

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- Require that
  - — consultation take place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);
  - — sufficient and appropriate resources be available to enable appropriate consultation to take place;
  - — all the relevant facts known to the engagement team be provided to those consulted;
  - — the nature, scope, and conclusions of such consultations be documented; and
  - — the conclusions resulting from such consultations be implemented.
- Require that
  - — differences of opinion be dealt with and resolved;
  - — conclusions reached are documented and implemented; and
  - — the report not be released until the matter is resolved.
- Require that
  - — all engagements be evaluated against the criteria for determining whether an engagement quality control review should be performed;
  - — an engagement quality control review be performed for all engagements that meet the criteria; and
  - — the review be completed before the report is released.
- Establish procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.
- Establish criteria for the eligibility of engagement quality control reviewers.

Monitoring

1.15 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports issued by the firm are appropriate in the circumstances

1.16 The objective of the monitoring element of quality control ordinarily would be satisfied by establishing and maintaining policies such as the following:

- Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.
- Assign performance of the monitoring process to competent individuals.
- Require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures. Monitoring procedures consist of the following:

  - Review of selected administrative and personnel records pertaining to the quality control elements
  - Review of engagement working papers, reports, and clients' financial statements
  - Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate that improvements are needed
  - Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures
  - Communication of the identified findings to appropriate firm management personnel
  - Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis
  - Assessment of
    - the appropriateness of the firm's guidance materials and any practice aids;
    - new developments in professional standards and regulatory and legal requirements and how they are reflected in the firm's policies and procedures where appropriate;
    - compliance with policies and procedures on independence;
    - the effectiveness of continuing professional development, including training;
    - decisions related to acceptance and continuance of client relationships and specific engagements; and
    - firm personnel's understanding of the firm's quality control policies and procedures and implementation thereof.
- Communicate at least annually, to relevant engagement partners and other appropriate personnel, deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.
- Communicate the results of the monitoring of its quality control system process to relevant firm personnel at least annually.
- Establish procedures designed to provide the firm with reasonable assurance that it deals appropriately with the following. This includes establishing clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisal and documenting complaints and allegations and the responses to them:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  - Allegations of noncompliance with the firm's system of quality control
  - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Require appropriate documentation to provide evidence of the operation of each element of its system of quality control. The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including the following, for example:
  - the size of the firm and the number of offices
  - the nature and complexity of the firm's practice and organization

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- Require retention of documentation providing evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

1.17 Some of the monitoring procedures discussed in the previous list may be accomplished through the performance of the following:

- Engagement quality control review
- Postissuance review of engagement working papers, reports, and clients' financial statements for selected engagements
- Inspection[4] procedures

Documentation of Quality Control Policies and Procedures

1.18 The firm should document each element of its system of quality control. The extent of the documentation will depend on the size, structure, and nature of the firm's practice. Documentation may be as simple as a checklist of the firm's policies and procedures or as extensive as practice manuals.

Applying the Quality Control Standards to Four Hypothetical Firms

1.19 Subsequent chapters in this practice aid present four different hypothetical firms and the quality control policies and procedures each firm implements to address each of the quality control elements. Following is a description of those firms and their characteristics:

- Multioffice CPA Firm has 10 offices in 3 states and is centrally managed. It has approximately 15 partners and 100 professionals. Its accounting and auditing practice has a concentration of financial institution clients for which it performs audit and attest services. Multioffice CPA Firm has no issuer clients. (chapter 2)
- Single office CPA Firm has 1 office, 3 partners, and 10 professionals. Its accounting and auditing practice has a concentration of employee benefit plan audits. Single office CPA Firm has no issuer clients. (chapter 3)
- Sole Practitioner, CPA, is a sole owner who has no professional staff and occasionally hires per diem professionals. Her accounting practice consists only of engagements subject to Statements on Standards for Accounting and Review Services (SSARSs). (chapter 4) (Note: Sole practitioners who perform audit and attest engagements should refer to chapter 3)
- Closely Aligned CPA Firm and Non-CPA-Owned Entity are organized in an *alternative practice structure*, which is a nontraditional structure in the practice of public accounting consisting of an attest and a nonattest portion of the practice. The attest portion is conducted through a firm, Closely Aligned CPA Firm, owned and controlled by CPAs. The nonattest portion is conducted through a separate entity, Non-CPA-owned Entity, owned and controlled by individuals who are not CPAs. (chapter 5)

1.20 The policies and procedures described in each chapter are those that a firm of a similar size and type may consider establishing and maintaining. The policies and procedures used by an actual firm need not necessarily include nor be limited to all those used by the illustrative firms.

[4] Inspection is a retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures, and the extent of the firm's compliance with them. Although monitoring procedures are meant to be ongoing, they may include inspection procedures performed at a fixed point in time. Monitoring is a broad concept; inspection is one specific type of monitoring procedure.

Chapter 2:

System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With Multiple Offices

2.01 This chapter describes how a CPA firm that has multiple offices (Multioffice CPA Firm) implements each element of quality control in its accounting and auditing practice. Multioffice CPA Firm is a hypothetical firm that has 10 offices in 3 states and is centrally managed. Multioffice CPA Firm has 15 partners, 100 professionals, and a concentration of financial institution clients for which it performs audit and attest services. The firm uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. These practice aids are supplemented by oral and written communications from the firm's partners. It has no issuer clients.[1]

Quality Control Policies and Procedures

2.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those polices. The policies and procedures are required to be documented. Multioffice CPA Firm documents its system of quality control by preparing a document that comprehensively describes policies and procedures established and maintained for each element of quality control. Multioffice CPA Firm reviews the documentation at least annually and updates it as necessary.

2.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

2.04 Multioffice CPA Firm communicates these policies and procedures in writing and makes the documentation available electronically to all professional personnel. Multioffice CPA Firm requires each individual to be familiar with and to comply with these policies and procedures. Multioffice CPA Firm also includes procedures for personnel to communicate their views or concerns on quality control matters to partners.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

2.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.06–.10.

2.06 *Policy 1: The firm's managing partner assumes ultimate responsibility for the firm's system of quality control.* Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner accept overall responsibility for the firm's system of quality control and promoting a quality-oriented culture by sending clear, consistent, and frequent messages through e-mails, letters, and recordings
- Having a mission statement that includes the firm's core values and the importance of quality
- Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action

[1] If Multioffice CPA Firm were to be engaged to perform audit services for an issuer, it might need to revise its quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.

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2.07 *Policy 2: The firm assigns management responsibilities so that commercial considerations do not override the quality of the work performed.* Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control
- Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality work

2.08 *Policy 3: The firm assigns operational responsibility for the firm's quality control system to personnel who have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a quality control partner with overall operational responsibility for developing and implementing appropriate policies and procedures for the firm's quality control system
- Designating a quality control individual for each office

2.09 *Policy 4: The firm designs procedures addressing performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel to demonstrate the firm's overarching commitment to the objectives of the system of quality control.* Multioffice CPA Firm implements this policy through the following procedures:

- Designing and implementing performance evaluation and advancement systems that (*a*) reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards and (*b*) include partner performance peer evaluations
- Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
  - — Takes into consideration firm feedback based on monitoring results and peer reviews of the work performed
  - — Rewards partners and personnel for timely (*a*) identification of significant and emerging accounting and auditing issues and (*b*) consultation with firm experts

2.10 *Policy 5: The firm devotes sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Providing the designated quality control partner with sufficient time, authority, and resources to develop, implement, and maintain the firm's quality control policies and procedures
- Providing the firm's quality control documentation to personnel when they are initially hired and reviewing the documentation with them
- Reviewing the firm's quality control policies and procedures with personnel at firm training sessions at least annually

Relevant Ethical Requirements

2.11 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.12–.18.

2.12 *Policy 1: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning one of its partners the responsibility of responding to questions, resolving matters, and determining the circumstances for which consultation with sources outside the firm is required for matters related to independence, integrity, and objectivity
- Identifying circumstances for which documentation of the resolution of matters is appropriate
- Maintaining a current list of (*a*) all entities with which firm personnel are prohibited from having a financial or business relationship and (*b*) all activities in which the firm is prohibited[2] from engaging, as defined in the firm's independence policies
- Establishing clear and concise written independence guidance covering relationships and activities that impair independence, including but not limited to investments, loans, brokerage accounts, business relationships, employment relationships, and fee arrangements

2.13 *Policy 2: The firm establishes procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.* Multioffice CPA Firm implements this policy through the following procedures:

- Having the managing partner (through e-mails, letters, or recordings) emphasize the concepts of independence, integrity, and objectivity in the firm's professional development meetings, in the acceptance and continuance of clients and engagements, and in the performance of engagements. Because Multioffice CPA Firm has a concentration of financial institution clients, this also includes discussing the applicability of these concepts to engagements for financial institutions, such as the prohibition against any member of the engagement team having a "nongrandfathered" loan with the institution, and the types of nonattest services that could affect independence.
- Requiring periodic independence and ethics training for all professional personnel. Such training covers the firm's independence and ethics policies and the independence and ethics requirements of all applicable regulators.
- Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity.
- Informing personnel on a timely basis of those entities to which independence policies apply by doing the following:
  - Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship
  - Making the list available to personnel so they may evaluate their independence (including personnel new to the firm or an office)
  - Notifying personnel of changes in the list

2.14 *Policy 3: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning a partner who is not otherwise associated with the engagement, or who practices in an office other than the office that performs the attest engagement, to review the engagement
- Requiring approval of the assignment of engagement personnel by another partner or manager
- Rotating engagement partners periodically

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[2] Examples of prohibited activities include providing certain valuation and information technology services to an audit client. See the rules of specific standard-setters to determine the extent and relevance of any prohibition.

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- Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (*a*) significant clients or (*b*) clients at which partners or other senior personnel are offered key management positions, or accept offers of employment, by utilizing the procedures contained in the AICPA Code of Professional Conduct, paragraphs .01 and .04 of ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, *Professional Standards*)
- Designating a senior-level partner to be responsible for overseeing the adequate functioning of the firm's independence policies
- Implementing a system to identify investment holdings of partners and managers that might impair independence
- Requiring all professionals to report, on a timely basis when identified, apparent violations of independence, integrity, or objectivity policies involving themselves, their spouses, or their dependents and the corrective actions taken or proposed to be taken
- Establishing a requirement for all professional personnel to notify the managing partner in each office of any potential activities that might impair independence or violate ethics rules, including services provided to entities with which firm personnel are prohibited from having a business relationship
- Establishing a program that protects professional personnel who report potential ethics or independence violations to the proper parties in compliance with firm policy
- Requiring the managing partner in each office, or a person designated by the managing partner, to periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence
- Developing guidance that sets forth the consequences for professional personnel who violate the firm's independence policies and procedures, including engaging in activities with entities with which firm personnel are prohibited from having a business relationship
- Requiring all professional personnel to review the list of entities with which firm personnel are prohibited from having a business relationship before a professional or the spouse or dependent of a professional obtains a security or financial interest in an entity
- Establishing criteria that determine the need for safeguards for engagements where monitoring procedures or peer review have identified weaknesses in previous years or the same senior personnel have been used for five years or more on an audit or attestation engagement
- Documenting any safeguards applied to eliminate threats to independence or reduce them to an acceptable level
- Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to (*a*) the engagement partner who, with the firm, needs to address the breach and (*b*) other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action
- Obtaining confirmation from the engagement partner and other relevant personnel that the required corrective actions have been taken

2.15 *Policy 4: The firm withdraws from engagements if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Multioffice CPA Firm implements this policy through the following procedures:

- Consulting within the firm and, if necessary, with legal counsel and other parties when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied
- Withdrawing from engagements when effective safeguards to reduce threats to independence to an acceptable level cannot be applied

2.16 *Policy 5: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements.* Multioffice CPA Firm implements this policy through the following procedures:

- Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm's independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation (such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a financial or business relationship)
- Assigning responsibility to the firm's quality-control partner for obtaining such written representations, reviewing independence compliance files for completeness, and resolving reported exceptions
- Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement

2.17 *Policy 6: The firm establishes procedures for confirming the independence of another firm or firm personnel in associated member firms who perform part of an engagement.* Multioffice CPA Firm implements this policy through the following procedures:

- Describing in its policies and procedures manual the form and content of independence representations, and frequency with which they are to be obtained
- Requiring that such representations be documented

2.18 *Policy 7: The firm rotates personnel for audit or attest engagements where regulatory or other authorities require such rotation after a specified period.* Multioffice CPA Firm implements this policy by having the quality control partner monitor regulatory requirements for financial institutions and other entities and notifying partners of the need for rotation. Multioffice CPA Firm has decided to rotate partners assigned to audit financial institutions every five years.

Acceptance and Continuance of Client Relationships and Specific Engagements

2.19 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

2.20 Multioffice CPA Firm satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 2.21–.25.

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2.21 *Policy 1: The firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.* Multioffice CPA Firm implements this policy through the following procedures:

- Developing and maintaining a manual that contains policies and procedures related to the acceptance of prospective clients and the continuance of existing clients. Such policies and procedures state that the firm's clients should not present undue risks to the firm, including damage to the firm's reputation.
- Advising professional personnel that they are expected to be familiar with the firm's policies and procedures for the acceptance and continuance of clients.
- Obtaining and evaluating relevant information before accepting or continuing any client. The following are examples of such information:
  - The nature and purpose of the services to be provided and management's understanding thereof.
  - The identity of the client's principal owners, key management, related parties, and those charged with its governance.
  - The nature of the client's operations, including its business practices, from sources such as annual reports, interim financial statements, reports to regulators, enforcement actions by regulators, and income tax returns.
  - Information obtained from inquiries of third parties about the client, its principal owners, key management, and those charged with governance that may have a bearing on evaluating the client. Examples of such third parties are bankers, factors, legal counsel, credit services, investment bankers, underwriters, and other members of the financial or business community who may have applicable knowledge. Inquiries also might be made regarding management's attitude toward compliance with regulators or legislative requirements and the presence of control deficiencies, especially those that management is unwilling to correct.
- Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion shopping.
- Assessing management's commitment to implementing and maintaining effective internal control.
- Assessing management's commitment to the appropriate application of generally accepted accounting principles (GAAP).
- Conducting a background check of the business, its officers, and the person(s) in question by using an investigative firm and evaluating the information obtained regarding management's integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after completing the steps listed previously, or when there is an indication that management or someone affiliated with the prospective client may be less than reputable.
- Evaluating the risk of providing services to significant clients or to other clients for which the firm's independence or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which the partner is compensated, and (*d*) the effect that losing the client would have on the partner and the firm.

2.22 *Policy 2: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to*

complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued. Multioffice CPA Firm implements this policy through the following procedures:

- Evaluating whether the following are in place:
  - — The practice office has sufficient personnel who have obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
  - — Specialists are available if needed, through, for example, the resources of another practice office or alternative source.
  - — The firm is able to complete the engagement within the reporting deadline.
- Defining high-risk engagements.
- Specifying conditions that trigger the requirement between annual audits to reevaluate a client or engagement. The following are examples of such conditions:
  - — Significant changes in the client, such as a major change in ownership, senior client personnel, directors, advisers, the nature of the business, or its financial stability.
  - — Changes in the nature or scope of the engagement, such as an initial public offering or a request to step down from an audit to a review engagement.
  - — Changes in the composition or strategic focus of the firm, such as the inability to replace the loss of key personnel who are particularly knowledgeable about a specialized industry or a decision by Multioffice CPA firm to discontinue services to clients in a particular industry.
  - — The existence of conditions that would have caused the firm to reject the engagement had such conditions existed at the time of the initial acceptance, such as aggressive earnings management, unreliable processes for developing accounting estimates, questionable estimates by management, questions regarding the entity's ability to continue as a going concern, and other factors that may increase the risk of being associated with the client.
  - — The client's delinquency in paying fees. (This may also affect the firm's independence.)
  - — Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
  - — Engagements for entities in the development stage.
  - — Engagements in which the client has ignored prior recommendations, such as recommendations that address deficiencies in internal control.
- Obtaining relevant information to determine whether the relationship should be continued and establishing the frequency with which client continuance evaluations should be made.
- Evaluating the information obtained regarding acceptance or continuance of a client or engagement through the following activities:
  - — The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.
  - — The engagement partner completes a client acceptance form and submits it to the managing partner of the practice office for approval.
  - — The engagement partner signs a step in the planning program noting that he or she has considered whether the client should be continued, and if conditions exist that trigger the requirement between annual audits to reevaluate a client or engagement, prepares a form documenting his or her rationale and conclusion regarding client continuance.

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— The partner responsible for the quality control function assesses and approves the recommendation made by the engagement partner. In certain defined circumstances, such as high-risk engagements, acceptance or continuance decisions also may require approval of the firm's managing partner.

- Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.

2.23 *Policy 3: The firm obtains an understanding with the client regarding the services to be performed.* Multioffice CPA Firm implements this policy by requiring that for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client's signature on that letter, thus minimizing the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed.

2.24 *Policy 4: The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Multioffice CPA Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal
- Discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement, or from both the engagement and the client relationship, if the firm determines that it is appropriate to withdraw

2.25 *Policy 5: The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Multioffice CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

2.26 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.27–.33.

2.27 *Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently.* Multioffice CPA Firm implements this policy by maintaining firm-wide hiring standards and evaluating the firm's personnel needs, including the following:

- Designating a partner or other qualified individual in each office to be responsible for evaluating the overall personnel needs in that practice office and establishing hiring objectives based on factors such as existing clientele, anticipated growth, personnel turnover, and individual advancement
- Developing and maintaining personnel policies and procedures that identify attributes, achievements, and experiences desired in entry-level and experienced personnel
- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Establishing guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions

- Preparing budgets that identify personnel needs at all levels
- Identifying sources of employment candidates such as universities and executive recruiters
- Selecting and training the individuals who will be interviewing candidates or otherwise participating in the hiring process
- Summarizing and evaluating the results of the hiring process for each candidate, including approval by the managing partner, or a person designated by the managing partner, of all hiring decisions

2.28 *Policy 2: The firm determines capabilities and competencies required for an engagement, including those required of the engagement partner.* Multioffice CPA Firm implements this policy by specifying the competencies that the engagement partner for an accounting, auditing, or attest engagement (or other person responsible for supervising and signing or authorizing someone to sign the firm's report on such engagements) should possess. Such competencies include having an understanding of the following:

- The role of the firm's system of quality control and the AICPA Code of Professional Conduct, both of which play critical roles in ensuring the integrity of the accounting, auditing, and attest function to users of reports.
- The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
- The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
- The professional standards applicable to the engagement being performed and to the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, as well as rules and regulations issued by applicable regulators.
- The skills that contribute to sound professional judgment, including the ability to exercise professional skepticism.
- How the organization uses information technology and the manner in which information systems are used to record and maintain financial information.

2.29 *Policy 3: The firm determines the capabilities and competencies possessed by personnel.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Evaluating personnel at least annually to determine their capabilities and competencies

2.30 *Policy 4: The firm assigns responsibility for each engagement to an engagement partner.* Multioffice CPA Firm implements this policy through the following procedures:

- Assigning the responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role
- Clearly defining and communicating the responsibilities of the partner to the engagement partner
- Communicating the identity and role of the partner to management and those charged with governance
- Developing and maintaining systems to monitor the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities

2.31 *Policy 5: The firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.* Multioffice CPA Firm implements this policy through the following procedures:

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- Designating an appropriate person(s) in each office to be responsible for assigning personnel to engagements based on such factors as the following:
  - Engagement type, size, significance, complexity, and risk profile
  - Specialized experience or expertise required and competencies gained through previous experience or education
  - Need for and availability of staff and supervisors
  - Timing of the work to be performed
  - Continuity and rotation of personnel
  - Opportunities for on-the-job training
  - Situations for which independence or objectivity concerns exist
- Designating a partner to be responsible for partner and manager assignments
- Requiring approval of partner and manager assignments from the industry partner or the quality assurance partner in the case of high-risk or significant client engagements
- Establishing a policy for monitoring the continuation and rotation of engagement partners

2.32 *Policy 6: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other applicable regulators.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a partner to oversee the development of firm requirements and materials for a professional development program covering subjects relevant to the firm's clients and services. Such responsibilities include the following:
  - Encouraging personnel to pass the Uniform CPA Examination
  - Establishing guidelines for participation by personnel in professional development programs and considering the requirements of the AICPA, state boards of accountancy, and applicable regulators in establishing the firm's CPE requirements
  - Maintaining appropriate documentation evidencing that personnel have met the professional education requirements of the firm, the AICPA, state boards of accountancy, and other applicable regulators
  - Providing an orientation program and training for new personnel to inform them of their professional responsibilities and firm policies
  - Preparing and providing publications and programs to inform personnel of their responsibilities and opportunities
  - Developing in-house staff training programs that focus on general and industry-specific accounting and auditing subjects, including audits of financial institutions
- Communicating and distributing to personnel changes in accounting, auditing, attestation, and quality control standards, as well as independence, integrity, and objectivity requirements and the firm's guidance with respect to those standards and requirements
- Encouraging professional personnel at each level in the firm to participate in external professional development activities such as the following:
  - CPE courses
  - Meetings of professional organizations
  - Serving on professional committees
  - Writing for professional publications

— Speaking to professional groups

2.33 *Policy 7: Personnel selected for advancement have the qualifications necessary to fulfill the responsibilities they will be called on to assume.* Multioffice CPA Firm implements this policy through the following procedures:

- Appointing a director of human resources to identify and communicate, in the firm's policies and procedures manual, the qualifications necessary to accomplish responsibilities at each professional level in the firm. This includes the following:
  - — Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.
  - — Developing evaluation forms for each professional staff classification, including partners. Such forms include evaluation of performance quality and adherence to ethical principals.
  - — Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.
- Assigning responsibility to a partner for making advancement and termination decisions for staff and recommendations to the firm's management committee for manager and partner-level advancement and termination. Such responsibilities include the following:
  - — Identifying responsibilities and requirements for evaluation at each level and indicating who will prepare these evaluations and when they will be prepared
  - — Reviewing evaluations on a timely basis with the individual being evaluated
- Advising personnel regarding their progress and career opportunities through the following procedures:
  - — Evaluating employees annually and at the end of each assignment exceeding three weeks to provide feedback on performance.
  - — Summarizing and reviewing with personnel their performance evaluations, including assessing their progress with the firm, at least annually. Considerations include past performance, future objectives of the firm and the individual, assignment preferences, and career opportunities.
  - — Evaluating partners periodically by means of performance reviews, peer evaluations, or self-appraisals, as appropriate, to provide feedback and to determine whether they continue to have the qualifications to accomplish their assigned responsibilities and to assume additional responsibilities.

Engagement Performance

2.34 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Multioffice CPA Firm satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 2.35–.45.

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2.35 *Policy 1: Planning for engagements meets professional, regulatory, and the firm's requirements.* Multioffice CPA Firm implements this policy by developing, maintaining, and providing personnel with the firm's policies and procedures manual that delineates the factors the engagement team should consider in the planning process and the extent of documentation of these considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:

- Assigning responsibility to the engagement partner for planning the engagement and assigning responsibilities to appropriate personnel during the planning phase
- Developing or updating background information about the client
- Considering client significance to the firm
- Requiring, for all initial audit clients designated as high risk by the firm, an independent review of planning considerations by either the engagement quality control reviewer or another partner
- Requiring planning documentation that includes the following:
    - Proposed work programs tailored to the specific engagement
    - Staffing requirements, including the need for personnel with specialized knowledge who may have to be obtained from other practice offices
    - Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement
    - Consideration of risks and how they may affect the procedures to be performed
    - A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm's quality control policies and procedures
    - Evidence of review of planning by an independent review partner

2.36 *Policy 2: The engagement is performed, supervised, reviewed, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm.* Multioffice CPA Firm implements this policy by requiring personnel to comply with the firm's policies and procedures manual, which prescribes the following:

- How engagement teams are supervised during the course of an engagement, including briefing the engagement team on the objectives of their work
- The form and content of documentation of the work performed and conclusions reached, including forms, checklists, and questionnaires to be used in performing engagements
- The form in which instructions are to be given to other offices or other auditors performing part of an engagement and the extent to which such work is to be reviewed and documented
- The extent of overall engagement review required, at all professional levels, to ensure that the financial statements meet professional and firm presentation and disclosure requirements
- The extent of review to be performed of required communications to management and the board of directors

2.37 *Policy 3: Qualified engagement team members review work performed by other team members on a timely basis.* Multioffice CPA Firm implements this policy through the following procedures:

- Adhering to the following firm guidelines regarding review of documentation of the work performed and conclusions reached, the financial statements, and reports and documentation of the review process:
    - All reviewers are to possess appropriate experience, competence, authority, and responsibility and are to be given access to the firm's reference material and other resources.

  - For each engagement, there is to be appropriate documentation evidencing review of the documentation of the work performed and conclusions reached, the financial statements, and the report.

- Assigning responsibility for the review of all reports, financial statements, and documentation of the work performed and conclusions reached to an appropriate reviewer in accordance with procedures outlined in the firm's manual to obtain reasonable assurance of the following:
  - The nature, timing, and extent of procedures performed are consistent with risk assessments and the approach described in the planning documentation. Exceptions are appropriately investigated. The appropriateness of planned procedures should be reconsidered if significant changes in risk factors occur or are identified between the planning phase of the engagement and the execution of procedures.
  - Firm-prescribed forms, checklists, and questionnaires, tailored as appropriate, are used in performing and reporting on the engagement.
- Requiring a second review, by a partner or manager, of the report, financial statements, and selected documentation of the work performed and conclusions reached, as prescribed in the firm's policies and procedures manual. The extent of review varies based on the type of engagement. For example, engagements for financial institutions, high-risk engagements, and those performed for significant clients, as defined by the firm, receive an engagement quality control review.
- Reviewing engagement documentation to determine whether the following has occurred:
  - The work has been performed in accordance with professional standards and regulatory and legal requirements.
  - Significant findings and issues have been raised for further consideration.
  - Appropriate consultations have taken place, and the resulting conclusions have been documented and implemented.
  - The nature, timing, and extent of work performed are appropriate and do not need revision.
  - The work performed supports the conclusions reached and is appropriately documented.
  - The evidence obtained is sufficient and appropriate to support the report.
  - The objectives of the engagement procedures have been achieved.

2.38 *Policy 4: Engagement teams complete the assembly of final engagement files on a timely basis.* Multioffice CPA Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

2.39 *Policy 5: The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing and applying controls to accomplish the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.
  - Prevent unauthorized changes to the engagement documentation.
  - Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

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- Requiring the use of a password by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users
- Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement
- Implementing procedures for properly distributing engagement documentation materials to the team members at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement
- Implementing procedures for restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
    - Generate scanned copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
    - Integrate the scanned copies into the engagement files, including indexing and signing off on the copies as necessary.
    - Enable the scanned copies to be retrieved and printed as necessary.

2.40 *Policy 6: The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing procedures that accomplish the following:
    - Enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time.
    - Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed.
    - Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.
- Retaining documentation for a specific period of time as appropriate for the nature of the engagement

2.41 *Policy 7: The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented.* Multioffice CPA Firm implements this policy through the following procedures:

- Providing personnel with the firm's policies and procedures manual that specifies the firm's consultation policies and procedures. Areas or specialized situations for which the firm requires consultation include the following:
    - Application of newly issued technical pronouncements.
    - Industries with special accounting, auditing, or reporting requirements.
    - Emerging practice problems.
    - Choices among alternative GAAP upon initial adoption or when an accounting change is made.
    - Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the date a report was issued.

- Filing requirements of regulators.
- Meetings with regulators at which the firm is to be called upon to support the application of GAAP or GAAS that have been questioned.
- Designating individuals within the firm as consultants in certain areas. Personnel are to consult with the designated individual when issues arise. If differences arise between the engagement partner and the consultant, the matter is to be resolved by the partner(s) responsible for the quality control function.

- Maintaining or providing access to adequate and up-to-date references, which includes materials related to specific industries, specialties, and regulatory requirements, in each office.
- Requiring that documentation of consultation include all relevant facts and circumstances, the sections of the professional literature used in making a determination, the conclusion reached, how the conclusions were implemented, and the signatures of the engagement partner and consultant. This documentation is to be retained with the engagement documentation of the work performed and conclusions reached. At the discretion of the consultant, the documentation may be entered in a retrievable database to promote efficiencies in the consultation process and consistency in the resolution of similar issues.

2.42 *Policy 8: The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved.* Multioffice CPA Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment within an engagement team be resolved by the engagement and quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.
- Requiring that the resolution of the differences be appropriately documented. If members of the engagement team continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

2.43 *Policy 9: The firm has criteria for determining whether an engagement quality control review should be performed; evaluates all engagements against the criteria; performs an engagement quality control review for all engagements that meet the criteria; and completes the review before the report is released.* Multioffice CPA Firm implements this policy by defining high-risk engagements and requiring that an engagement quality control review be performed for all high-risk engagements, engagements for financial institutions, and engagements performed for significant clients.

2.44 *Policy 10: The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.* Multioffice CPA Firm implements this policy through the following procedures:

- Implementing procedures addressing the timing of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor's report but is required to be completed before the report is released. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor's report is changed to the date by which sufficient appropriate audit evidence has been obtained.
- Implementing procedures addressing the nature and extent of the review. The firm's procedures for audit and attestation engagements require that the engagement quality control reviewer do the following:
  - Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.

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  - Discuss with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions, and account balances.
  - Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
  - Review documentation of the resolution of significant accounting, auditing, and financial reporting issues, including documentation of consultation with firm personnel or external sources.
  - Review the summary of uncorrected misstatements that are related to known and likely misstatements.
  - Review additional engagement documentation to the extent considered necessary.
  - Read the financial statements and report and consider whether the report is appropriate.
  - Confirm with the engagement partner that there are no significant unresolved issues.
  - Complete the review before the release of the report.
  - Determine whether the issues raised in the review indicate a need to change the auditor's report date.
- Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.
- Implementing procedures addressing documentation by the engagement quality control reviewer. The firm's procedures require documentation of the following:
  - That the procedures required by the firm's policies on engagement quality control review have been performed
  - That the engagement quality control review has been completed before the report is released
  - That no matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate

2.45 *Policy 11: The firm establishes criteria for the eligibility of engagement quality control reviewers.* Multioffice CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

- Is not selected by the engagement partner
- Has sufficient technical expertise and experience
- Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the engagement partner and the engagement quality control reviewer
- Does not assume any of the responsibilities of the engagement partner or have responsibility for the audit of any significant subsidiaries, divisions, benefit plans, or affiliated or related entities
- Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team
- Does not make decisions for the engagement team or participate in the performance of the engagement, except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement

Monitoring

2.46 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

2.47 Multioffice CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 2.48–.51.

2.48 *Policy 1: The firm assigns responsibility for the monitoring process to a partner and assigns performance of the monitoring process to competent individuals.* Multioffice CPA Firm implements this policy through the following procedures:

- Designating a partner with appropriate authority to be responsible for quality assurance, including ensuring that the firm's quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
  - Mergers and divestitures of portions of the practice
  - Changes in professional standards and other regulatory requirements applicable to the firm's practice
  - Results of inspections and peer reviews
  - Reviews of litigation and regulatory enforcement actions against the firm and others
  - Changes in applicable AICPA membership requirements
- Preparing inspection checklists and guidance materials or using materials prepared by the AICPA for performing inspection procedures.
- Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.
- Identifying the need to take the following actions:
  - Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed
  - Improve compliance with firm policies and procedures related to the other elements of quality control
- Assigning performance of the monitoring process to the designated quality control individual for each practice office.

2.49 *Policy 2: The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.* Multioffice CPA Firm implements this policy through the following procedures:

- Developing and performing the firm's inspection program to obtain feedback about the effectiveness of the firm's policies and procedures.

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- Reviewing the resolution of matters reported by professional personnel on independence-confirmation forms to determine that matters have been appropriately considered and resolved.
- Interviewing personnel at all professional management and staff levels to obtain information about operating procedures in practice offices, whether personnel are knowledgeable about firm policies and procedures, and whether such policies and procedures are being effectively communicated.
- Reviewing the following documentation to determine compliance with firm policies and procedures:
  - — Personnel evaluations, including documentation of hiring and advancement decisions
  - — Documentation of client acceptance and continuance decisions
  - — Participants' evaluations of practice office training programs
  - — Professional development records of personnel
  - — Correspondence regarding the resolution of independence matters within the practice office
- Developing a plan to test a sample of engagements for compliance with the firm's policies and procedures. Such a review may be preissuance or postissuance.
- Reviewing a cross-section of engagements from selected practice offices using the following criteria for inclusion in the sample selected:
  - — Engagements involving all partners and managers who have significant accounting and auditing responsibilities in the selected offices
  - — Engagements for financial institutions
  - — First-year engagements
  - — Significant client engagements
  - — Specialized industries, with emphasis given to high-risk industries
  - — Level of service performed (audit, review, compilation, and attestation)
  - — Level of attestation services performed (examination, review, and agreed-upon procedures)
  - — Engagements for which there have been complaints or allegations that the work performed by the firm fails to comply with professional standards, regulatory requirements, or the firm's system of quality control
  - — Engagements in which there were significant disagreements between the quality review partner and the engagement partner
- Periodically reviewing the process for personnel evaluation and counseling to ascertain the following:
  - — Procedures for evaluation and documentation are being followed on a timely basis
  - — Personnel who have been promoted have achieved the applicable requirements for advancement
  - — Personnel decisions are consistent with evaluations
  - — Recognition is given to outstanding performance
- Designating a partner or qualified individual in each office to review the summary of the evaluations of in-house training programs to determine whether the programs are achieving their objectives.

- Designating a partner or qualified individual in each office to review summaries of CPE records for that office's professional staff to determine that the office has established a means of tracking each individual's compliance with the requirements of the AICPA and other applicable regulators.
- Interviewing selected professional personnel regarding the effectiveness of training programs.
- Considering the results of the firm's inspection as they relate to the effectiveness of the firm's professional development program.
- Ascertaining whether inquiries received by individuals consulted within the firm indicate the need for additional CPE programs.
- Reviewing and updating firm practice aids, such as audit programs, forms, and checklists, to reflect new or revised professional pronouncements.
- Issuing guidance regarding new professional standards, regulatory requirements, and related changes to firm policy.
- Soliciting comments from partners and managers as to the effectiveness of practice aids and tools.

2.50 *Policy 3: The firm communicates at least annually (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel.* Multioffice CPA Firm implements this policy through the following procedures:

- Preparing a summary monitoring report for the firm's senior management that evaluates the overall results of the inspection and other monitoring procedures and reaches final conclusions as to whether the firm as a whole needs to improve compliance with the firm's policies and procedures and whether revisions to the firm's quality control policies and procedures are necessary.
- Communicating findings to practice office personnel and determining the corrective actions to be taken for the engagements reviewed. These findings are discussed and communicated in a report issued to each office. The practice office responds regarding the specific corrective actions or steps to be taken to improve compliance with the firm's policies and procedures and professional standards.
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).
- Communicating in partner-manager meetings and firm policy correspondence the need for changes in the system of quality control.
- Communicating in training programs, partner-manager meetings, and firm policy correspondence the need for improved compliance with the system of quality control.

2.51 *Policy 4: The firm deals appropriately with complaints and allegations.* Multioffice CPA Firm implements this policy through the following procedures:

- Establishing procedures for concerns to be brought to the attention of the ethics committee in a confidential manner
- Having the firm's ethics committee (excluding any members who are otherwise involved in the engagement under investigation) investigate the following:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  - Allegations of noncompliance with the firm's system of quality control
  - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Consulting with legal counsel as necessary

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- Documenting complaints and allegations and the responses to them

2.52 *Policy 5: The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Multioffice CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected
- A record of the evaluation of the following:
  - — Adherence to professional standards and regulatory and legal requirements
  - — Whether the quality control system has been appropriately designed and effectively implemented
  - — Whether the firm's quality control policies and procedures have been appropriately applied
- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

2.53 *Policy 6: The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time.* Multioffice CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

Chapter 3:

System of Quality Control for a CPA Firm's Accounting and Auditing Practice—Firm With a Single Office

3.01 This chapter describes how a CPA firm that has a single office (Single office CPA Firm) implements each element of quality control in its accounting and auditing practice. Single office CPA Firm is a hypothetical firm with 1 office, 3 partners, and a total of 10 professionals. Its accounting and auditing practice has a concentration of employee benefit plans, and the firm has no issuer clients.[1] The firm uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. These practice aids are supplemented by oral and written communications from the firm's partners.

Quality Control Policies and Procedures

3.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those polices. The policies and procedures are required to be documented. Single office CPA Firm documents its system of quality control by preparing a document that comprehensively describes the policies and procedures for each element of quality control. Single office CPA Firm reviews the documentation at least annually and updates it as necessary.

3.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

3.04 Single office CPA Firm communicates these policies and procedures in writing and makes the documentation available electronically to all professional personnel. Single office CPA Firm requires each individual to be familiar with and to comply with these policies and procedures. Single office CPA Firm encourages its personnel to communicate their views or concerns about quality control matters to partners.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

3.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.06–.10.

3.06 *Policy 1: The firm's managing partner assumes ultimate responsibility for the firm's system of quality control.* Single office CPA Firm implements this policy through the following procedures:

- Having the managing partner accept ultimate responsibility for the firm's system of quality control and for setting a tone that emphasizes the importance of quality and of following the firm's system of quality control
- Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action

3.07 *Policy 2: Commercial considerations do not override the quality of the work performed.* Single office CPA Firm implements this policy through the following procedures:

[1] If Single office CPA Firm were to be engaged to perform audit services for an issuer, it might need to revise its quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.

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- Having the managing partner continually evaluate client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control
- Emphasizing to all personnel that fee considerations and scope of services should not infringe upon quality work

3.08 *Policy 3: Responsibility for developing, implementing, and operating the firm's quality control system is assigned to personnel with sufficient and appropriate experience, authority, and ability.* Single office CPA Firm implements this policy by having the managing partner designate a quality control partner who is responsible for designing, implementing, and monitoring the firm's quality control system.

3.09 *Policy 4: Performance evaluation, compensation, and advancement (including incentive systems) with regard to personnel demonstrate the firm's overarching commitment to the objectives of the system of quality control.* Single office CPA Firm implements this policy through the following procedures:

- Designing and implementing performance evaluation and advancement systems that reward partners and staff involved in the accounting and auditing practice for the quality of their work and their compliance with professional standards.
- Establishing a compensation system that provides incentives to accounting and auditing partners and senior-level employees for the quality of their accounting and auditing work. The compensation system does the following:
  - — Takes into consideration firm feedback based on monitoring results and peer reviews of the work performed
  - — Rewards partners and personnel for timely (*a*) identification of significant and emerging accounting and auditing issues and (*b*) consultation with firm experts

3.10 *Policy 5: The firm devotes sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.* Single office CPA Firm implements this policy through the following procedures:

- Providing the designated quality control partner with sufficient time, authority, and resources to develop, implement, and maintain the firm's quality control policies and procedures
- Providing the firm's quality control documentation to personnel when they are initially hired and reviewing the documentation with them
- Reviewing the firm's quality control policies and procedures with personnel at firm training sessions at least annually

Relevant Ethical Requirements

3.11 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.12–.17.

3.12 *Policy 1: Personnel adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators.* Single office CPA Firm implements this policy through the following procedures:

- Designating a quality assurance partner to review relevant pronouncements relating to independence, integrity, and objectivity; answer questions; determine the circumstances for which consultation with sources outside the firm is required; and resolve matters
- Providing personnel with access to the AICPA *Professional Standards* service

- Establishing a system for identifying all services performed for each client and evaluating whether any of those services might impair independence

3.13 *Policy 2: The firm establishes procedures to communicate independence requirements to firm personnel and, where applicable, others subject to them.* Single office CPA Firm implements this policy through the following procedures:

- Informing personnel of those entities to which independence policies apply by doing the following on a timely basis:
  - Preparing and maintaining a list of entities with which firm personnel are prohibited from having a financial or business relationship
  - Making the list available to personnel so they may evaluate their independence (including personnel new to the firm)
  - Notifying personnel of changes in the list
- Providing frequent reminders of professional responsibilities to personnel, such as avoiding behavior that might be perceived as impairing their independence or objectivity

3.14 *Policy 3: The firm establishes procedures to identify and evaluate possible threats to independence and objectivity, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards.* Singleoffice CPA Firm implements this policy through the following procedures:

- Requiring the engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall impact, if any, on independence requirements
- Accumulating and communicating relevant information to appropriate personnel so that the following can occur:
  - The firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements.
  - The firm can maintain and update information relating to independence.
  - The firm and the engagement partner can take appropriate action regarding identified threats to independence.
- Requiring personnel to promptly report circumstances and relationships that create a threat to independence, and independence breaches of which they become aware, so that appropriate action can be taken
- Establishing criteria to determine the need for safeguards for engagements where the following have taken place:
  - Monitoring procedures or peer review has identified weaknesses in previous years.
  - The same senior personnel have been used for five years or more on an audit or attestation engagement.
- Promptly communicating identified breaches of these policies and procedures, and the required corrective actions, to the following personnel:
  - The engagement partner who, with the firm, needs to address the breach
  - Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action
- Requiring the engagement partner and the other individuals referred to in the previous list to confirm to the firm that the required corrective actions have been taken

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- Having a partner, or an individual designated by the partner, periodically review unpaid fees from clients to ascertain whether any outstanding amounts impair the firm's independence
- Establishing additional procedures that provide safeguards when the firm performs audit or other attest work for (*a*) significant clients or (*b*) clients at which partners or other senior personnel are offered key management positions or have accepted offers of employment

3.15 *Policy 4: The firm withdraws from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Single office CPA Firm implements this policy through the following procedures:

- Consulting within the firm, and with legal counsel and other parties if necessary, when the firm believes that effective safeguards to reduce threats to independence to an acceptable level cannot be applied
- Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied

3.16 *Policy 5: The firm obtains written confirmation, at least annually, of compliance with its policies and procedures on independence from all firm personnel required to be independent by relevant requirements.* Single office CPA Firm implements this policy through the following procedures:

- Obtaining written representations from personnel, upon hire and on an annual basis, stating that they have read the firm's independence, integrity, and objectivity policies, understand the applicability of those policies to their activities, and have complied with the requirements of those policies since their last representation. (Such written representations are accompanied by the most current list of all entities with which firm personnel are prohibited from having a business relationship.)
- Reviewing these independence representations for completeness and resolving reported exceptions.
- Requiring the engagement partner to sign a step in the engagement program attesting to compliance with independence requirements that apply to the engagement.

3.17 *Policy 6: The firm establishes procedures for confirming the independence of another firm that performs part of the engagement.* Single office CPA Firm implements this policy through the following procedures:

- Using practice aids that prescribe the form and content of independence representations, and frequency with which they are to be obtained
- Requiring that such representations be documented

Acceptance and Continuance of Client Relationships and Specific Engagements

3.18 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;

- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

3.19 Single office CPA Firm satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 3.20–.24.

3.20 *Policy 1: The firm evaluates factors that have a bearing on management's integrity and considers the risk associated with providing professional services in particular circumstances.* Single office CPA Firm implements this policy through the following procedures:

- Informing personnel of the firm's policies and procedures for accepting and continuing clients, including those outlined in the firm's practice aids.
- Obtaining and evaluating relevant information such as the following before accepting or continuing a client:
  - The nature and purpose of the services to be provided and management's understanding thereof
  - The identity of the client's principal owners, key management, related parties, and those charged with its governance
  - Information obtained from inquiries of the client's bankers, factors, attorneys, credit services, and others who have business relationships with the entity
  - The nature of the client's operations, including its business practices, from sources such as annual reports, interim financial statements, reports to and from regulators, income tax returns, and credit reports
  - Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting
- Evaluating the risk of providing services for the following engagements:
  - Engagements for entities operating in highly specialized or regulated industries, including financial institutions, governmental entities, and employee benefit plans
  - Engagements that require an inordinate amount of time to complete relative to the available resources of the firm
- Communicating with the predecessor accountant or auditor when required or recommended by professional standards. This communication also includes inquiries regarding the nature of any disagreements and whether there is evidence of opinion-shopping.
- Conducting a background check of the business, its officers, and the person(s) in question by using the services of an investigative company and evaluating the information obtained regarding management's integrity. Background checks are conducted when the firm is unable to obtain sufficient information about the prospective client after taking the steps described previously, or there is an indication that management or someone affiliated with the prospective client may be less than reputable.
- Evaluating the risk of providing services to significant clients or to other clients for which the firm's objectivity or the appearance of independence may be impaired. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement, (*b*) the effect on the partner's stature within the firm as a result of his or her service to the client, (*c*) the manner in which

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the partner is compensated, and (*d*) the effect that losing the client would have on the partner and the firm.

3.21 *Policy 2: The firm evaluates whether the engagement can be completed with professional competence; undertakes only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluates, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.* Single office CPA Firm implements this policy through the following procedures:

- Evaluating whether the firm has obtained or can reasonably expect to obtain the knowledge and expertise necessary to perform the engagement, including relevant regulatory or reporting requirements.
- Evaluating whether the following are in place:
  - — The firm has sufficient personnel with the necessary capabilities and competence.
  - — Specialists are available if needed.
  - — Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, when needed.
  - — The firm is able to complete the engagement within the reporting deadline.
- Specifying conditions that trigger the requirement to reevaluate a specific client or engagement. The following are examples of such conditions:
  - — Significant changes in the client, such as a major change in senior client personnel, ownership, advisers, the nature of its business, or the financial stability of the client.
  - — Changes in the nature or scope of the engagement, including requests for additional services.
  - — Changes in the composition of the firm, such as the loss of and inability to replace key personnel who are particularly knowledgeable about a specialized industry.
  - — The decision to discontinue services to clients in a particular industry.
  - — The existence of conditions that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance.
  - — The client's delinquency in paying fees. (This may also affect the firm's independence.)
  - — Engagements for entities operating in highly specialized or regulated industries, such as financial institutions, governmental entities, and employee benefit plans.
  - — Engagements for entities in which there may be substantial doubt about the entity's ability to continue as a going concern.
  - — Engagements in which the client has ignored prior recommendations, such as those that address deficiencies in internal control.
- Obtaining relevant information to determine whether the relationship should be continued and establishing a frequency for evaluations (for example, continuance decisions are made at least annually).
- Evaluating the information obtained regarding acceptance or continuance of the client or engagement through the following activities:

  a. The engagement partner assesses the information obtained about the client or the specific engagement, including information about the significance of the client to the firm, and makes a recommendation about whether the client or engagement should be accepted or continued.

  b. The engagement partner completes a client acceptance form and submits it to the managing partner for approval.

c. The engagement partner signs a step in the planning program noting consideration of client continuance and completes a form documenting the rationale and conclusion regarding client continuance if conditions exist that trigger the requirement to reevaluate a client or engagement between annual audits.

d. The managing partner assesses and approves the recommendation made by the engagement partner. If the managing partner recommends not accepting a client or discontinuing a client relationship, the managing partner discusses his or her reasons for the acceptance or continuance decision with the other partners.

- Establishing procedures for dealing with information that would have caused the firm to decline the engagement if the information had been available earlier.

3.22 *Policy 3: The firm obtains an understanding with the client regarding the services to be performed.* Single office CPA Firm implements this policy by requiring that, for all engagements, the firm prepare a written engagement letter documenting the understanding with the client and obtain the client's signature on that letter, thus minimizing the risk of misunderstanding regarding the nature, scope, and limitations of the services to be performed.

3.23 *Policy 4: The firm establishes procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Single office CPA Firm implements this policy through the following procedures:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place or for the firm to report to regulatory authorities the withdrawal from the engagement, or from both the engagement and the client relationship, together with the reasons for the withdrawal
- Discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship if the firm determines that it is appropriate to withdraw

3.24 *Policy 5: The firm documents how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Single office CPA Firm implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

3.25 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.26–.32.

3.26 *Policy 1: Personnel who are hired possess the characteristics that enable them to perform competently.* Single office CPA Firm implements this policy through the following procedures:

- Designating an individual in the firm to be responsible for the following activities:
  - Managing the human resources function
  - Evaluating the firm's personnel needs by considering factors such as existing clientele, anticipated growth, personnel turnover, and individual advancement
  - Developing criteria for determining which individuals will be involved in the interviewing and hiring process

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- Establishing an understanding among the partners about the attributes, achievements, and experiences desired in entry-level and experienced personnel
- Setting guidelines for the additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions

3.27 *Policy 2: The firm determines capabilities and competencies required for an engagement, including those required of the engagement partner.* Single office CPA Firm implements this policy by specifying the competencies that the engagement partners of the firm's accounting, auditing, and attestation engagements (or other persons responsible for supervising and signing or authorizing someone to sign the firm's report on such engagements) should possess. These competencies include having an understanding of the following:

- The role of the firm's system of quality control and the AICPA Code of Professional Conduct in ensuring the integrity of the accounting, auditing, and attest functions to users of reports.
- The performance, supervision, and reporting aspects of the engagement, which ordinarily are gained through training or participation in similar engagements.
- The industry in which the client operates, including its organization and operating characteristics, sufficient to identify areas of high or unusual risk associated with the engagement and to evaluate the reasonableness of industry-specific estimates.
- The professional standards applicable to the engagement and the industry in which the client operates. Such standards include accounting, auditing, and attestation standards, as well as rules and regulations issued by applicable regulators.
- The skills that contribute to sound professional judgment, including the ability to exercise professional skepticism.
- How the organization uses information technology and the manner in which information systems are used to record and maintain financial information.

3.28 *Policy 3: The firm determines the capabilities and competencies possessed by personnel.* Single office CPA Firm implements this policy through the following procedures:

- Establishing criteria for evaluating personal characteristics such as integrity, competence, and motivation
- Evaluating personnel at least annually to determine their capabilities and competencies

3.29 *Policy 4: The firm assigns the responsibility for each engagement to an engagement partner.* Single office CPA Firm implements this policy through the following procedures:

- Assigning responsibility for each engagement to an engagement partner who has the appropriate capabilities, competence, authority, and time to perform the role
- Clearly defining and communicating the responsibilities of the partner to the engagement partner
- Communicating the identity and role of the partner to management and those charged with governance
- Monitoring the workload and availability of engagement partners to enable these individuals to have sufficient time to adequately discharge their responsibilities

3.30 *Policy 5: The firm assigns personnel (including partners) based on the knowledge, skills, and abilities required in the circumstances and the nature and extent of supervision needed.* Single office CPA Firm implements this policy through the following procedures:

- Designating an appropriate person to be responsible for assigning personnel to engagements based on such factors as the following:
    - Engagement type, size, significance, complexity, and risk profile

    - Specialized experience and expertise required for the engagement and competencies gained through prior experience
    - Personnel availability
    - Timing of the work to be performed
    - Continuity and rotation of personnel
    - Opportunities for on-the-job training
    - Situations for which independence or objectivity concerns exist
- Designating a partner to be responsible for partner and manager assignments
- Requiring approval of partner and manager assignments from the managing partner or other partner in the case of high-risk or significant client engagements

3.31 *Policy 6: Personnel participate in general and industry-specific continuing professional education (CPE) and professional development activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other regulators.* Single office CPA Firm implements this policy through the following procedures:

- Encouraging personnel to pass the Uniform CPA Examination
- Assigning responsibility to a partner to maintain a professional development program that does the following:
    - Requires personnel to participate in professional development programs in accordance with firm guidelines and in subjects that are relevant to their responsibilities
    - Takes into account the requirements of the AICPA, state boards of accountancy, and other regulatory agencies in establishing the firm's CPE requirements
    - Provides CPE course materials to, and maintains records of completed CPE for, professional personnel
    - Provides an orientation and training program for new hires
- Encouraging participation by personnel at each level in the firm in other professional development activities such as completing external professional development programs, including graduate-level and self-study courses, becoming members of professional organizations, serving on professional committees, writing for professional publications, and speaking to professional groups
- Communicating and distributing to personnel, when applicable, changes in accounting, auditing, attestation, and quality control standards, as well as independence requirements and the firm's guidance with respect to those standards and requirements

3.32 *Policy 7: Personnel selected for advancement have the qualifications to fulfill the responsibilities they will be called on to assume.* Single office CPA Firm implements this policy through the following procedures:

- Assigning responsibility to the three partners to jointly make advancement and termination decisions. Such responsibilities include the following:
    - Establishing criteria for evaluating personnel at each professional level and for advancement to the next higher level of responsibility. Such criteria give recognition and reward to the development and maintenance of competence and commitment to ethical principles.
    - Informing firm personnel about the criteria for advancement to the next higher level of responsibility.
    - Designating personnel responsible for preparing evaluations and determining when they should be prepared.

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— Informing personnel that failure to adhere to the firm's policies and procedures regarding performance quality and commitment to ethical principles may result in disciplinary action.

— Using forms that include the applicable qualifications when evaluating the performance of personnel. Such forms include qualifications related to performance quality and adherence to ethical principles.

— Reviewing evaluations on a timely basis with the individual being evaluated.

- Counseling personnel regarding their progress and career opportunities by doing the following:

  — Evaluating employees annually and at the end of each assignment lasting four weeks or longer to provide feedback on performance.

  — Summarizing and reviewing with personnel annually the evaluation of their performance, including an assessment of their progress with the firm. Considerations include past performance, future objectives of the individual and the firm, the individual's assignment preferences, and career opportunities.

  — Evaluating partners periodically by means of counseling, peer evaluation, or self-appraisal, as appropriate.

Engagement Performance

3.33 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the engagement partner issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Single office CPA Firm satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 3.34–.44.

3.34 *Policy 1: Planning for engagements meets professional, regulatory, and the firm's requirements.* Single office CPA Firm implements this policy by maintaining and providing personnel with the firm's practice aids that prescribe the factors the engagement team should consider in the planning process and the extent of documentation of those considerations. Planning considerations may vary depending on the size and complexity of the engagement. Planning generally includes the following activities:

- Assigning responsibilities to appropriate personnel during the planning phase
- Developing or updating background information on theclient and the engagement
- Considering client significance to the firm
- Developing a planning document that includes the following:

  — Proposed work programs tailored to the specific engagement

  — Staffing requirements and the need for specialized knowledge

  — Consideration of the economic conditions affecting the client and its industry and their potential effect on the conduct of the engagement

  — The risks, including fraud considerations, affecting the client and the engagement and how the risks may affect the procedures performed

  — A budget that allocates sufficient time for the engagement to be performed in accordance with professional standards and the firm's quality control policies and procedures

3.35 *Policy 2: The engagement is performed, supervised, documented, and reported (or communicated) in accordance with the requirements of professional standards, applicable regulators, and the firm.* Single office CPA Firm implements this policy through the following procedures:

- Providing adequate supervision during the course of an engagement, including briefing the engagement team on the objectives of their work. The training, ability, and experience of the personnel are considered when assigning supervisors to the engagement.
- Requiring that a written work program be used in all engagements.
- Addressing significant issues arising during the engagement, considering their significance, and appropriately modifying the planned approach.
- Adhering to the guidelines set forth by the firm for the form and content of documentation of the work performed and conclusions reached. Such documentation includes standardized forms, checklists, and questionnaires used in the performance of engagements and explanations, when required, of how the firm integrates such aids into engagements.
- Requiring engagement documentation in accordance with professional standards, applicable regulatory requirements, and the firm's policies.

3.36 *Policy 3: Qualified engagement team members review work performed by other team members on a timely basis.* Single office CPA Firm implements this policy by adhering to the following guidelines established by the firm regarding review of the documentation of the work performed and conclusions reached, the financial statements and reports, and documentation of the review process:

- All reviewers are to have appropriate experience, competence, and responsibility.
- For each engagement, there is to be evidence of appropriate review of documentation of the work performed and conclusions reached, the financial statements, and the report.
- Engagement documentation is reviewed to determine whether the following have occurred:
  - The work has been performed in accordance with professional standards and regulatory and legal requirements.
  - Significant findings and issues have been raised for further consideration.
  - Appropriate consultations have taken place, and the resulting conclusions have been documented and implemented.
  - The nature, timing, and extent of work performed are appropriate and do not need revision.
  - The work performed supports the conclusions reached and is appropriately documented.
  - The evidence obtained is sufficient and appropriate to support the report.
  - The objectives of the engagement procedures have been achieved.

3.37 *Policy 4: Engagement teams complete the assembly of final engagement files on a timely basis.* Single office CPA Firm implements this policy by completing the assembly of final engagement files in accordance with professional standards and applicable regulatory requirements, if any.

3.38 *Policy 5: The firm maintains the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Single office CPA Firm implements this policy through the following procedures:

- Establishing and applying controls to accomplish the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.

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- Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means.
- Prevent unauthorized changes to the engagement documentation.
- Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

- Implementing procedures for properly distributing engagement documentation materials to engagement teams at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement
- Implementing procedures to restrict access to, and enable proper distribution and confidential storage of, hardcopy engagement documentation
- Requiring the use of passwords by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users
- Implementing appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
    - Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
    - Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
    - Enable the copies to be retrieved and printed as necessary.

3.39 *Policy 6: The firm retains engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Single office CPA Firm implements this policy through the following procedures:

- Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards
- Establishing procedures that
    - enable the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time;
    - provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed; and
    - enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

3.40 *Policy 7: The firm requires that consultation take place when appropriate; that sufficient and appropriate resources are available to enable appropriate consultation to take place; that all the relevant facts known to the engagement team are provided to those consulted; that the nature, scope, and conclusions of such consultations are documented; and that conclusions resulting from such consultations are implemented.* Single office CPA Firm implements this policy through the following procedures:

- Consulting with those having appropriate knowledge, authority, and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical, and other matters. Single office CPA firm uses advisory services provided by other firms, professional and regulatory bodies, and commercial organizations that provide relevant quality control services. Before using such services, the firm evaluates whether the external provider is qualified for that purpose.

- Informing personnel of the firm's consultation policies and procedures.
- Requiring sufficiently experienced engagement team members to identify matters for consultation or consideration during the engagement.
- Requiring consultation in specialized areas or situations with appropriate individuals within and outside the firm when matters such as the following arise:
    - — The application of newly issued technical pronouncements
    - — Industries with special accounting, auditing, or reporting requirements, including unusually complex employee benefit plans
    - — Emerging practice problems
    - — Choices among alternative generally accepted accounting principles upon initial adoption or when an accounting change is made
    - — Reissuance of a report, consideration of omitted procedures after a report has been issued, or subsequent discovery of facts that existed at the date a report was issued
    - — Filing requirements of regulators
    - — Meetings with regulators at which the firm is to be called on to support the application of generally accepted accounting principles or generally accepted auditing standards that have been questioned
- Providing all professional personnel with access to adequate and current reference materials.
- Including all relevant facts, circumstances, the professional literature used, and conclusions reached in the engagement documentation of the work performed and conclusions reached.
- Documenting the issue on which consultation was sought and the results of the consultation, including any decisions taken, the basis for those decisions, and how they were implemented. If there is an unresolved disagreement, an outside source may be consulted to assist in determining the appropriate application of accounting principles.

3.41 *Policy 8: The firm deals with and resolves differences of opinion, documents and implements conclusions reached, and does not release the report until the matter is resolved.* Single office CPA Firm implements this policy through the following procedures:

- Requiring that all differences of professional judgment among members of an engagement team be resolved by the engagement and the quality control partners, and the managing partner if necessary, and that the report not be released until the matter is resolved.
- Requiring that conclusions reached be appropriately documented. If members of the team continues to disagree with the resolution, they may disassociate themselves from the resolution of the matter and may document that a disagreement continues to exist.

3.42 *Policy 9: The firm has criteria for determining whether an engagement quality control review should be performed, evaluates all engagements against the criteria, performs an engagement quality control review for all engagements that meet the criteria, and completes the review before the report is released.* Singleoffice CPA Firm implements this policy through the following procedures:

- Establishing criteria such as the following:
    - — The identification of unusual circumstances or risks in an engagement or class of engagements as determined by the engagement partner or quality control partner
    - — An engagement quality control review is required by law or regulation
- Evaluating all engagements against the criteria
- Performing an engagement quality control review for all engagements that meet the criteria

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3.43 *Policy 10: The firm establishes procedures addressing the nature, timing, extent, and documentation of the engagement quality control review.* Single office CPA Firm implements this policy through the following procedures:

- Implementing procedures addressing the nature, timing, and extent of the review. The firm has concluded that performing an engagement quality control review is not necessary to obtain sufficient appropriate audit evidence for audit engagements; therefore, the engagement quality control review does not need to be completed before the date of the auditor's report. When the engagement quality control review results in additional audit procedures being performed, the date of the auditor's report is changed to the date by which sufficient appropriate audit evidence has been obtained. The firm's procedures require that for audit and attestation engagements, the engagement quality control reviewer do the following:
    - — Discuss significant accounting, auditing, and financial reporting issues with the engagement partner, including matters for which there has been consultation.
    - — Discuss with the engagement partner the engagement team's identification and audit of high-risk assertions, transactions and account balances.
    - — Confirm with the engagement partner that there are no significant unresolved issues.
    - — Review selected working papers relating to the significant judgments the engagement team made and the conclusions they reached.
    - — Review documentation of the resolution of significant accounting, auditing, or financial reporting issues, including documentation of consultation with firm personnel or external sources.
    - — Review the summary of uncorrected misstatements related to known and likely misstatements.
    - — Review additional engagement documentation to the extent considered necessary.
    - — Read the financial statements and the report and consider whether the report is appropriate.
    - — Complete the review before the release of the report. The review may be conducted at appropriate stages during the engagement.
    - — Determine whether the issues raised in the review indicate a need to change the auditor's report date.
- Resolving conflicting opinions between the engagement partner and the engagement quality control reviewer regarding significant matters. The policy requires documentation of the resolution of conflicting opinions before the release of the audit report.
- Implementing procedures addressing documentation by the engagement quality control reviewer. The firm's procedures require documentation of the following:
    - — The procedures required by the firm's policies on engagement quality control review have been performed.
    - — The engagement quality control review has been completed before the report is released.
    - — No matters have come to the attention of the engagement quality control reviewer that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

3.44 *Policy 11: The firm establishes criteria for the eligibility of engagement quality control reviewers.* Single office CPA Firm implements this policy by establishing the following criteria for an engagement quality control reviewer:

- Is selected by the quality control partner or the managing partner

- Has sufficient technical expertise and experience
- Carries out his or her responsibilities with objectivity and due professional care without regard to the relative positions of the audit engagement partner and the engagement quality control reviewer
- Meets the independence requirements relating to the engagements reviewed, even though the engagement quality control reviewer is not a member of the engagement team
- Does not make decisions for the engagement team or participate in the performance of the engagement except that the engagement partner may consult the engagement quality control reviewer at any stage during the engagement

When the firm does not have suitably qualified personnel to perform the engagement quality control review, the firm contracts with a suitably qualified external person to perform the engagement quality control review.

Monitoring

3.45 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

3.46 Single office CPA Firm satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 3.47–.56.

3.47 *Policy 1: The firm assigns responsibility for the monitoring process, including performance, to a partner or competent individual.* Single office CPA Firm implements this policy through the following procedures:

- Designating a partner or senior personnel to be responsible for quality assurance, including ensuring that the firm's quality control policies and procedures and its methodologies remain relevant and adequate. Factors to be considered include the following:
    - — Mergers and divestitures of portions of the practice
    - — Changes in professional standards or other regulatory requirements applicable to the firm's practice
    - — Results of inspections and peer reviews
    - — Review of litigation and regulatory enforcement actions against the firm and its personnel
    - — Changes in applicable AICPA membership requirements
- Determining whether personnel have been appropriately informed of their responsibilities for maintaining the firm's standards of quality in performing their duties.
- Identifying the need to do the following:
    - — Revise policies and procedures related to the other elements of quality control because they are ineffective or inappropriately designed.
    - — Improve compliance with firm policies and procedures related to the other elements of quality control.

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3.48 *Policy 2: The firm performs monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.*

3.49 For purposes of illustrating Policy 2, two scenarios are described. Scenario 1 illustrates how Single office CPA Firm would satisfy the objective of Policy 2 by reviewing engagements throughout the year. Scenario 2 illustrates how Single office CPA Firm would implement Policy 2 by performing an annual inspection, thereby reviewing engagements during a designated period in the year.

3.50 *Scenario 1: Monitoring by Reviewing Engagements Throughout the Year.* Single office CPA Firm implements Policy 2 through the following procedures:

- Designating a partner or management-level individual not previously associated with the engagement to perform either a preissuance or postissuance review of the engagement.
- Establishing the approach for performing preissuance or postissuance reviews, for example, the comprehensiveness of the review and the frequency for summarizing findings (such as monthly or quarterly). The comprehensiveness of the review of selected engagements is similar to that performed in an inspection or peer review.
- Designating the forms and checklists to be used during the engagement and functional element reviews and the extent of the documentation required. (Examples of functional elements are the human resources function and the firm's library.)
- Selecting a cross-section of engagements at the beginning of the monitoring year for preissuance or postissuance review and reevaluating that selection throughout the year as circumstances dictate. Criteria used for selecting engagements include the following:
    - — Significant specialized industries with emphasis on high-risk engagements
    - — Audits of the financial statements of employee benefit plans
    - — First-year engagements
    - — Significant client engagements
    - — Level of service performed (that is, audit and attest, review, or compilation)
    - — Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities
    - — Engagements performed under *Government Auditing Standards* (Yellow Book engagements)
    - — Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory requirements, or the firm's system of quality control
    - — Engagements in which there were significant disagreements between the review partner and the engagement partner
- Reviewing the selected engagements. Deficiencies identified as a result of this process are summarized and evaluated to determine whether the following are necessary:
    - — Additional emphasis on specific areas or industries in future engagements
    - — Modifications to existing policies and procedures to prevent the deficiencies noted from recurring
- Reviewing other engagement files at least annually for compliance with the firm's quality control policies and procedures including reviewing correspondence regarding consultation on independence, integrity, and objectivity matters (for example, assessments of significant clients) and acceptance and continuance decisions.

- Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- Preparing a summary of the deficiencies noted resulting from the preissuance and postissuance reviews so that the partner may incorporate any recommended changes into the firm's policies and procedures.
- Communicating to all professional personnel the deficiencies noted and related changes in quality control procedures.
- Following up on planned corrective actions to determine whether the actions were taken as planned and whether they achieved the intended objectives.

3.51 *Scenario 2: Monitoring by Inspecting a Sample of Engagements During a Designated Period of the Year.* Single office CPA Firm implements Policy 2 through the following procedures:

- Designating a partner to be responsible for performing an annual inspection using guidance prepared by the AICPA for performing inspection procedures. These procedures include reviewing a cross-section of engagements using the following criteria in selecting engagements:
  - — Significant specialized industries with emphasis on high-risk engagements
  - — Audits of the financial statements of employee benefit plans
  - — First-year engagements
  - — Significant client engagements
  - — Level of service performed (that is, audit and attest, review, or compilation)
  - — Engagements performed by all partners and other management-level personnel having accounting and auditing responsibilities
  - — Engagements performed under *Government Auditing Standards* (Yellow Book engagements)
  - — Engagements for which there have been complaints or allegations from firm personnel, clients, or other third parties that the work performed by the firm failed to comply with professional standards, regulatory requirements, or the firm's system of quality control
  - — Engagements in which there were significant disagreements between the quality review partner and the engagement partner
- Establishing an approach and timetable for performing the inspection procedures and determining the forms and checklists to be used during the inspection and the extent of documentation required.
- Deciding how long to retain detailed inspection documentation (as opposed to summaries).
- Reviewing correspondence regarding consultation on independence, integrity, and objectivity matters and acceptance and continuance decisions.
- Reviewing the resolution of matters reported by professional personnel regarding independence to determine that matters have been appropriately considered and resolved.
- Selecting a sample of engagements for review to determine compliance with the firm's quality control policies and procedures, reevaluating that selection throughout the process, and reviewing the selected engagements.
- Preparing a summary inspection report for the partner or management group that evaluates the overall results of the inspection and sets forth any recommended changes that should be made to the firm's policies and procedures.
- Reviewing the recommended corrective actions and reaching final conclusions about the actions to be taken.
- Communicating inspection findings and quality control changes to all professional personnel.

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- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s).

3.52 In addition to the procedures described under Scenarios 1 or 2, Single office CPA Firm also implements Policy 2 through the following procedures:

- Reviewing and evaluating firm practice aids, such as audit programs, forms, and checklists, and considering whether they reflect recent professional pronouncements
- Providing information during staff meetings regarding new professional standards, regulatory requirements, and the related changes that should be made to firm practice aids
- Reviewing, or designating a management-level individual to be responsible for reviewing, the professional development policies and procedures to determine whether they are appropriate, effective, and meet the needs of the firm
- Reviewing, or designating a management-level individual to review summaries of the CPE records of the firm's professional personnel to evaluate each individual's compliance with the requirements of the AICPA and other applicable regulators
- Reviewing other administrative and personnel records pertaining to the quality control elements
- Soliciting information from the firm's personnel during staff meetings regarding the effectiveness of training programs

3.53 *Policy 3: The firm communicates (a) deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action to relevant engagement partners and other appropriate personnel and (b) the results of the monitoring of its quality control system process to relevant firm personnel at least annually.* Single office CPA Firm implements this policy through the following procedures:

- Preparing a summary report for the partners that evaluates the overall results of the monitoring and sets forth any recommended changes that should be made to the firm's policies and procedures
- Reviewing the recommended corrective actions and reaching final conclusions as to the actions to be taken
- Communicating to all professional personnel the deficiencies noted and the related changes in quality control procedures
- Following up on planned corrective actions to determine whether those actions were taken and whether they achieved the intended objective(s)

3.54 *Policy 4: The firm deals appropriately with complaints and allegations.* Single office CPA Firm implements this policy through the following procedures:

- Having the managing partner inform personnel that they may raise any concerns regarding complaints or allegations about noncompliance with professional standards, regulatory and legal requirements, or the firm's system of quality control with any partner without fear of reprisals.
- Having a partner who is not otherwise involved in the engagement investigate the following:
  - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
  - Allegations of noncompliance with the firm's system of quality control
  - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Documenting complaints and allegations and the responses to them.

3.55 *Policy 5: The firm prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Single office CPA Firm implements this policy by designing its summary monitoring report to provide evidence of the operation of each element of its system of quality control, including the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be inspected
- A record of the evaluation of the following:
  - — Adherence to professional standards and regulatory and legal requirements
  - — Whether the quality control system has been appropriately designed and effectively implemented
  - — Whether the firm's quality control policies and procedures have been appropriately applied so that reports that are issued by the firm or engagement partners are appropriate in the circumstances
- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

3.56 *Policy 6: The firm retains documentation providing evidence of the operation of the system of quality control for an appropriate period of time*. Single office CPA Firm implements this policy by requiring retention of the summary monitoring report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

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Chapter 4:

System of Quality Control for a CPA Firm's Accounting Practice—Sole Practitioner

4.01 This chapter describes how a sole practitioner (Sole Practitioner, CPA) implements each element of quality control in her accounting practice. Sole Practitioner, CPA, is a hypothetical firm of which Sole Practitioner, CPA, is the sole owner. The firm has no professional staff; however, on occasion Sole Practitioner, CPA, hires per-diem professionals. Her accounting practice consists only of engagements subject to SSARSs. She uses practice aids that have been subjected to peer review in accordance with standards established by the AICPA. Sole Practitioner, CPA, uses per-diem personnel to assist her and recognizes that her policies and procedures would have to change if she were to perform audit or attest engagements or hire full-time or part-time professional staff.

Quality Control Policies and Procedures

4.02 The firm's system of quality control consists of policies designed to achieve the objectives of the system and the procedures necessary to implement and monitor compliance with those policies. The policies and procedures are required to be documented. Sole Practitioner, CPA, documents her system of quality control by filling out checklists and questionnaires such as those included in the AICPA Peer Review Program Manual. Sole Practitioner, CPA, reviews the documentation at least annually and updates it as necessary.

4.03 The firm should communicate its quality control policies and procedures to its personnel. Effective communication includes the following:

- A description of quality control policies and procedures and the objectives they are designed to achieve
- The message that each individual has a personal responsibility for quality

4.04 Sole Practitioner, CPA, meets this requirement with regard to herself by annually reviewing the checklists and questionnaires used to document each element of her system of quality control. Sole Practitioner, CPA, communicates her policies and procedures to per-diem professionals when they are initially contracted for an engagement by holding a discussion with them and follows up on individual engagements. Sole Practitioner, CPA, requires per-diem personnel to be familiar with and to comply with these policies and procedures.

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

4.05 The objective of the leadership responsibilities element of a system of quality control is to promote an internal culture based on the recognition that quality is essential in performing engagements. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.06–.08.

4.06 *Policy 1: I am ultimately responsible for the firm's system of quality control.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Accepting responsibility for the firm's system of quality control
- Educating herself about requirements for a system of quality control
- Designing and implementing policies and procedures required for her firm's system of quality control

4.07 *Policy 2: Commercial considerations do not override the quality of the work performed.* Sole Practitioner, CPA, implements this policy by continually evaluating client relationships and specific engagements so that commercial considerations do not override the objectives of the system of quality control.

4.08 *Policy 3: I devote sufficient and appropriate resources for the development, communication, and support of the firm's quality control policies and procedures.* Sole Practitioner, CPA, implements this policy by reviewing and updating the quality control policies, procedures, and documentation on an annual basis.

Relevant Ethical Requirements

4.09 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.10–.13.

4.10 *Policy 1: I adhere to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, the GAO, and any other applicable regulators.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Subscribing to the AICPA *Professional Standards* service.
- Consulting the AICPA website for information about changes in professional ethics and independence standards.
- Reviewing unpaid client fees to ascertain whether any outstanding amounts impair the firm's independence.
- Reviewing relevant pronouncements published in the *Journal of Accountancy* relating to independence, integrity, and objectivity and retaining relevant issues of the *Journal of Accountancy*.
- Attending periodic professional training in ethics and independence.
- Complying with SSARSs by disclosing in the accountant's compilation report instances in which the firm is not independent.
- Considering the significance of each client to the firm. In broad terms, the significance of a client to a firm refers to relationships that could diminish a practitioner's objectivity and independence in performing attest services. In determining the significance of a client, the firm considers (*a*) the amount of time the partner devotes to the engagement and (*b*) the effect that losing the client would have on the firm.

4.11 *Policy 2: I communicate independence requirements to per-diem professionals.* Sole Practitioner, CPA, implements this policy by making per-diem personnel aware of financial, family, business, and other relationships that may be prohibited by applicable requirements.

4.12 *Policy 3: I establish procedures to identify and evaluate possible threats to independence and objectivity and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards. I withdraw from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Considering relevant information about client engagements, including the scope of services, to enable her to evaluate the overall impact on independence
- Consulting with AICPA Ethics Hotline with concerns about possible threats to independence
- Accumulating and communicating relevant information to per-diem personnel as appropriate so that the following can occur:
    - Sole Practitioner, CPA, and per-diem personnel can readily determine whether they satisfy independence requirements.
    - Sole Practitioner, CPA, can maintain and update information relating to independence.
    - Sole Practitioner, CPA, can take appropriate action regarding identified threats to independence.

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- Requiring per-diem personnel to promptly notify her of independence breaches of which they become aware, and circumstances and relationships that create a threat to independence, so that appropriate action can be taken
- Documenting any safeguards applied to eliminate threats to independence or reduce them to an acceptable level
- Withdrawing from the engagement if effective safeguards to reduce threats to independence to an acceptable level cannot be applied

4.13 *Policy 4: I confirm, in writing, my compliance with policies and procedures on independence and require written confirmation from all per-diem professionals required to be independent by relevant requirements.* Sole Practitioner, CPA, implements this policy by signing a step on each engagement program attesting to her independence and requiring per-diem personnel to do the same.

Acceptance and Continuance of Client Relationships and Specific Engagements

4.14 The objective of the quality control element that addresses acceptance and continuance of client relationships and specific engagements is to establish criteria for deciding whether to accept or continue a client relationship and whether to perform a specific engagement for a client. A firm's client acceptance and continuance policies represent a key element in mitigating litigation and business risk. Accordingly, it is important that a firm be aware that the integrity and reputation of a client's management could reflect the reliability of the client's accounting records and financial representations and, therefore, affect the firm's reputation or involvement in litigation. A firm's policies and procedures related to the acceptance and continuance of client relationships and specific engagements should provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where it

- has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- is competent to perform the engagement and has the capabilities and resources to do so;
- can comply with legal and ethical requirements; and
- has reached an understanding with the client regarding the services to be performed.

4.15 Sole Practitioner, CPA, satisfies this objective, both with respect to the initial period for which the firm is performing its service and for subsequent periods, by establishing and maintaining the policies and procedures described in paragraphs 4.16–.20.

4.16 *Policy 1: I evaluate factors that have a bearing on management's integrity and consider the risk associated with providing professional services in particular circumstances.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Obtaining information such as the following before accepting or continuing a client:
  - The nature and purpose of the services to be provided
  - The identity of the client's principal owners, key management, related parties, and those charged with its governance
  - The nature of the client's operations, including its business practices, from sources such as prior-year reports, internally generated financial statements (if applicable), income tax returns, and credit reports
  - Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting
- Inquiring of third parties such as bankers, factors, and legal counsel about management's business reputation and integrity.

- Communicating with the predecessor accountant when required or suggested by professional standards.[1]
- Evaluating the information obtained regarding management's integrity.
- Evaluating the risk of providing review services to significant clients or to other clients for which Sole Practitioner's, CPA, objectivity or the appearance of independence may be impaired. In determining the significance of a client, Sole Practitioner, CPA, considers the amount of time she devotes to the engagement and the effect that losing the client would have on her practice.

4.17 *Policy 2: I evaluate whether the engagement can be completed with professional competence; undertake only those engagements for which the firm has the capabilities, resources, and professional competence to complete; and evaluate, at the end of specific periods or upon occurrence of certain events, whether the relationship should be continued.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing a cut-off date by which evaluations of engagements should be performed, for example, before work on the current-year engagement begins
- Considering conditions, such as the following, that require reevaluation of a client or specific engagement and obtaining the relevant information to determine whether the relationship should be continued:
  - Significant changes in the client, for example, a major change in ownership, senior client personnel, directors, advisers, the nature of the business, or the financial stability of the client.
  - Changes in the nature or scope of the engagement, including requests for additional services.
  - Client significance.
  - Matters that would have caused the firm to reject the client or engagement had such conditions existed at the time of the initial acceptance. If such matters exist, Sole Practitioner, CPA, considers the professional and legal responsibilities that apply to the circumstances and the possibility of withdrawing from the engagement or both the engagement and the client relationship.
  - The client's delinquency in paying fees. (This also may affect the firm's independence.)
- Determining if she has, or can reasonably obtain, the knowledge and expertise to perform the engagement
- Evaluating the information obtained regarding the engagement, making the acceptance or continuance decision, and documenting her evaluation or conclusion in a memorandum or by signing off next to the relevant item in a practice aid

4.18 *Policy 3: I obtain an understanding with the client regarding the services to be performed.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Adhering to all requirements set forth in professional standards regarding obtaining an understanding with the client
- Requiring that the understanding with the client be documented either through an engagement letter or in a memorandum

[1] AR section 400, *Communications Between Predecessor and Successor Accountants* (AICPA, *Professional Standards*), provides guidance on communications between a predecessor and successor accountant when the successor accountant decides to communicate with the predecessor accountant. It also requires a successor accountant who becomes aware of information that leads him or her to believe the financial statements reported on by the predecessor accountant may require revision to request that the client communicate this information to the predecessor accountant.

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4.19 *Policy 4: I follow established procedures on withdrawal from an engagement or from both the engagement and the client relationship.* Sole Practitioner, CPA, implements this policy by discussing the issues and her conclusion with the appropriate level of the client's management and those charged with its governance. If she considers it necessary, she also discusses her decision with her attorney.

4.20 *Policy 5: I document how issues relating to acceptance or continuance of client relationships and specific engagements were resolved.* Sole Practitioner, CPA, implements this policy by documenting, in a memorandum to the engagement files, significant issues, consultations, conclusions, and the basis for the conclusions relating to acceptance or continuance of client relationships and specific engagements.

Human Resources

4.21 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.22–.23.

4.22 *Policy 1: I hire per-diem personnel of integrity who possess the characteristics that enable them to perform competently.* Sole Practitioner, CPA, implements this policy by setting criteria, regarding such factors as education, certification or licensure, and experience, that per-diem personnel must meet to be hired.

4.23 *Policy 2: I maintain the knowledge, skills, and abilities required in the circumstances by participating in general and industry-specific continuing professional education (CPE) and professional development activities that enable me to accomplish my responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state boards of accountancy, and other applicable regulators. I also monitor the compliance of per-diem employees with CPE requirements.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Maintaining the competencies necessary to accomplish responsibilities related to each of the firm's engagements
- Establishing a professional development program that takes into account the requirements of the AICPA and state boards of accountancy
- Participating in external professional development programs, including graduate-level and self-study courses
- Joining and becoming an active member of professional organizations
- Serving on professional committees, writing for professional publications on topics she is knowledgeable about, and participating in other professional activities
- Considering changes in the applicable professional standards when determining her professional development program
- Setting criteria that per-diem personnel must meet to competently perform engagements, such as the following examples:
    — Determining that per-diem personnel are in compliance with the applicable professional education requirements of the AICPA, state boards of accountancy, and state CPA societies
    — Obtaining and retaining documentation of such compliance
- Evaluating the knowledge and expertise required to perform an engagement prior to accepting the client or engagement
- Reading professional publications, such as state society journals, to keep abreast of changes in accounting standards and any industry-specific pronouncements that affect the client
- Consulting the AICPA website for information about changes in professional standards

Engagement Performance

4.24 The objective of the engagement performance element of quality control is to provide the firm with reasonable assurance (*a*) that engagements are consistently performed in accordance with applicable professional standards and regulatory and legal requirements and (*b*) that the firm or the practitioner-in-charge issues reports that are appropriate in the circumstances. Policies and procedures for engagement performance should address all phases of the design and execution of the engagement, including engagement performance, supervision responsibilities, and review responsibilities. Policies and procedures also should require that consultation takes place when appropriate. In addition, a policy should establish criteria against which all engagements are to be evaluated to determine whether an engagement quality control review should be performed. Sole Practitioner, CPA, satisfies these objectives by establishing and maintaining the policies and procedures described in paragraphs 4.25–.32.

4.25 *Policy 1: I plan engagements to meet professional standards, regulatory requirements, and the firm's requirements.* Sole Practitioner, CPA, implements this policy by adhering to professional standards regarding the planning process and the extent of documentation of the planning, if applicable. Engagement planning considerations may include the following:

- Developing or updating client information.
- Assessing the significance of the client to her firm.
- Obtaining an engagement letter for engagements performed under SSARSs. AR section 100, *Compilation and Review of Financial Statements* (AICPA, *Professional Standards*), requires the accountant to either issue a compilation report or document an understanding with the entity through the use of an engagement letter when the accountant submits financial statements to a client that are not expected to be used by a third party.
- Reviewing prior financial statements and accountants' reports.
- Using work programs and applicable reporting and disclosure checklists.

4.26 *Policy 2: I perform, supervise, review, document, and report (or communicate) in accordance with the requirements of professional standards.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Requiring the use of appropriate practice aids in all engagements
- Maintaining the availability of current practice aids and AICPA professional standards
- Briefing per-diem personnel on the engagement so that they understand the objectives of their work
- Documenting the work performed in accordance with professional standards and the firm's policy
- Supervising per-diem personnel as appropriate based on the following:
  - Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation
  - Understanding of professional standards and regulatory and legal requirements
  - Technical knowledge, including knowledge of relevant information technology
  - Knowledge of relevant industries in which the client operates
  - Ability to apply professional judgment
  - Understanding of the firm's quality control policies and procedures
  - Experience level
- Reviewing and initialing all engagement documentation prepared by per-diem personnel

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4.27 *Policy 3: I complete the assembly of final engagement files on a timely basis.* Sole Practitioner, CPA, implements this policy by completing the assembly of final engagement files on a timely basis in accordance with professional standards and applicable regulatory requirements, if any.

4.28 *Policy 4: I maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing and applying controls to do the following:
  - Clearly determine when and by whom engagement documentation was prepared and reviewed.
  - Protect the integrity of the information at all stages of the engagement.
  - Prevent unauthorized changes to the engagement documentation.
  - Allow access to the engagement documentation by per-diem personnel and other authorized parties as necessary to properly discharge their responsibilities.
- Tracking the distribution of engagement documentation materials to the per-diem personnel at the start of the engagement, preparing engagement documentation during the engagement, and assembling final documentation at the end of the engagement
- Restricting access to, and enabling proper distribution and confidential storage of, hardcopy engagement documentation
- Using passwords or data encryption, or both, to restrict access to electronic engagement documentation to authorized users
- Using appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement
- Implementing procedures regarding original paper documents that have been electronically scanned or otherwise copied to another media that accomplish the following:
  - Generate copies that contain the entire content of the original paper documentation, including manual signatures, cross-references, and annotations.
  - Integrate the copies into the engagement files, including indexing and signing off on the copies as necessary.
  - Enable the copies to be retrieved and printed as necessary.

4.29 *Policy 5: I retain engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Retaining engagement documentation for a period of time sufficient to meet the requirements of the state board of accountancy and applicable professional standards
- Enabling the retrieval of, and access to, the engagement documentation during the retention period, particularly in the case of electronic documentation because the underlying technology may be upgraded or changed over time
- Providing, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed
- Enabling authorized external parties to access and review specific engagement documentation for quality control or other purposes

4.30 *Policy 6: I require that consultation take place when appropriate; I make sufficient and appropriate resources available to enable appropriate consultation to take place; I provide to those consulted all the relevant facts known to me; I document the nature, scope, and conclusions of such consultations; and I implement conclusions resulting from such consultations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Maintaining current technical references to assist in resolving practice problems
- Referring to the AICPA's Technical Hotline or other qualified individuals if a practice problem arises for which the firm needs additional expertise
- Requiring that documentation of consultation include the following:
  - All relevant facts and circumstances about the issue on which consultation was sought.
  - References to professional literature used in the analysis of the matter.
  - The results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented. This documentation is retained with the engagement documentation.

4.31 *Policy 7: I deal with and resolve differences of opinion; I document and implement the conclusions reached; and I do not release the report until the matter is resolved.* Sole Practitioner, CPA, implements this policy by (*a*) evaluating issues of professional judgment when differences of opinion arise with per-diem personnel, with those consulted, or with an external reviewer and (*b*) resolving the matter before releasing the report. If persons involved in the engagement continue to disagree with the resolution, they may disassociate themselves from the resolution of the matter and document that a disagreement continues to exist.

4.32 *Policy 8: I have criteria for determining whether an engagement quality control review should be performed; I evaluate all engagements against the criteria before I accept the engagement; I contract with a qualified external person to perform the engagement quality control review; and I do not release the report until the review is completed.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Establishing the following criteria for determining whether an engagement quality control review should be performed:
  - The engagement is subject to Statements on Auditing Standards or Statements on Standards for Attestation Engagements.
  - An initial engagement for a client is in a specialized industry in which Sole Practitioner, CPA, has had no previous experience.
  - An engagement quality control review is required by law or regulation.
- Evaluating all engagements against the criteria
- Contracting with a qualified external person to perform the engagement quality control review
- Not releasing the report until the review is completed

Monitoring

4.33 The objective of the monitoring element of a system of quality control is to provide the firm with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the firm are appropriate in the circumstances

4.34 Sole Practitioner, CPA, satisfies this objective by establishing and maintaining the policies and procedures described in paragraphs 4.35–.39.

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4.35 *Policy 1: I perform monitoring procedures that are sufficiently comprehensive to enable me to assess compliance with all applicable professional standards and the firm's quality control policies and procedures.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Performing a postissuance review of selected engagements at least annually[2]
- Summarizing the findings from the firm's monitoring procedures at least annually and considering the systemic causes of findings that indicate improvements are needed
- Determining any corrective actions or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures and taking those actions, including necessary modifications to the quality control system, on a timely basis
- Reviewing compliance with the firm's policies and procedures related to relevant ethical responsibilities, including independence, human resources, acceptance and continuance of client relationships and specific engagements, and engagement performance
- Reviewing all policies and procedures and revising those affected by changes in professional standards or the nature of her practice
- Reviewing and determining that the firm's practice aids are current and reflect recent professional pronouncements and changes in her practice
- Reviewing CPE records to determine whether the classroom training and self-study programs she uses are appropriate for the firm's practice
- Reviewing CPE records to determine compliance with the requirements of the AICPA and other applicable regulatory agencies

4.36 *Policy 2: I deal appropriately with complaints and allegations.* Sole Practitioner, CPA, implements this policy through the following procedures:

- Investigating the following:
    - Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
    - Allegations of noncompliance with the firm's system of quality control
    - Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations
- Documenting complaints and allegations and the responses to them

4.37 *Policy 3: I prepare appropriate documentation to provide evidence of the operation of each element of the firm's system of quality control.* Sole Practitioner, CPA, implements this policy by documenting evidence of the operation of each element of the firm's system of quality control by preparing a memorandum of the following:

- Monitoring procedures, including the procedure for selecting completed engagements to be subject to postissuance review
- A record of the evaluation of the following:
    - Adherence to professional standards and regulatory and legal requirements
    - Whether the quality control system has been appropriately designed and effectively implemented

[2] A postissuance review may be performed as part of an inspection. A sole proprietor may consider engaging another CPA to perform the inspection to obtain a fresh look at the engagement. See paragraph 3.52, "Scenario 2: Monitoring by Inspecting a Sample of Engagements During a Designated Period of the Year," for a description of how a firm considers and evaluates, on an ongoing basis, compliance with a firm's policies and procedures by performing an annual inspection. Note that a preissuance review by the sole proprietor does not satisfy the monitoring requirements.

- — Whether the firm's quality control policies and procedures have been appropriately applied so that reports that are issued by the firm are appropriate in the circumstances
- Identification of the deficiencies noted, an evaluation of their effects, and the basis for determining whether further action is necessary and what that action should be

4.38 Although the form and content of that documentation is a matter of judgment, the illustration in table 1 in this chapter is an example of such documentation.

4.39 *Policy 4: I retain documentation of evidence of the operation of the system of quality control for an appropriate period of time.* Sole Practitioner, CPA, implements this policy by requiring retention of the summary report for a period of time sufficient to meet the firm's peer review or other regulatory requirements.

Table 1: Summary of Quality Control Monitoring For the Calendar Year 20XX

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Leadership Responsibilities for Quality Within the Firm		**These policies are evidenced by the overall operation of the firm's system of quality control.**
Relevant Ethical Requirements		
Policy 1. Adhering to relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes, and other applicable regulators	JB 6/30/XX	Independence confirmation files
Policy 2. Communicating independence requirements to per-diem professionals and, where applicable, others subject to them	JB 6/30/XX	Independence confirmation files
Policy 3. Establishing procedures to help mitigate possible threats to my independence and objectivity	JB 6/30/XX	Independence confirmation files
Policy 4. Confirming, in writing, my compliance with policies and procedures on independence and obtaining written confirmation from all per-diem professionals required to be independent by relevant requirements	JB 6/30/XX	Independence confirmation files
Acceptance and Continuance of Client Relationships and Specific Engagements		
Policy 1. Evaluating factors that have a bearing on management's integrity and considering the risk associated with providing professional services in particular circumstances	JB 6/30/XX	Client acceptance files and client engagement files

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Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Policy 2. Accepting or continuing to perform only those engagements that I can complete with professional competence and evaluating whether the relationship should be continued	JB 6/30/XX	Engagement files
Policy 3. Obtaining an understanding with the client regarding services to be performed	JB 6/30/XX	Engagement files
Policy 4. Following established procedures on withdrawal from an engagement or from both the engagement and the client relationship	JB 6/30/XX	Not applicable for year ended 20XX
Policy 5. Documenting how issues relating to acceptance or continuance of client relationships and specific engagements were resolved	JB 6/30/XX	Client acceptance files and client engagement files
Human Resources		
Policy 1. Hiring per-diem personnel of integrity who possess the characteristics that enable them to perform competently	JB 6/30/XX	Personnel files
Policy 2. (*a*) Maintaining the knowledge, skills, and abilities required in the circumstances by participating in general and industry-specific continuing professional education (CPE) and professional development activities that enable me to accomplish my responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA society, state boards of accountancy, and other applicable regulators and (*b*) monitoring for compliance the CPE requirements of per-diem employees	JB 6/30/XX	Personnel files
Engagement Performance		
Policy 1. Planning engagements to meet professional standards, regulatory requirements, and the firm's requirements	JB 6/30/XX	Engagement files
Policy 2. Performing, supervising, reviewing, documenting, and reporting (or communicating) in accordance with the requirements of professional standards	JB 6/30/XX	Engagement files
Policy 3. Completing the assembly of final engagement files on a timely basis	JB 6/30/XX	Engagement files
Policy 4. Maintaining the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation	JB 6/30/XX	Engagement files

(continued)

Element of Quality Control and Applicable Policies	*Reviewer's Initials and Date Reviewed*	*Location of Additional Documentation*
Policy 5. Retaining engagement documentation for a period of time sufficient to meet the needs of the firm, professional standards, laws, and regulations	JB 6/30/XX	Engagement files
Policy 6. Requiring that consultation take place when appropriate; making sufficient and appropriate resources available to enable appropriate consultation to take place; providing to those consulted all the relevant facts known to me; documenting the nature, scope, and conclusions of such consultations; and implementing conclusions resulting from such consultations	JB 6/30/XX	Engagement files
Policy 7. Dealing with and resolving differences of opinion; documenting and implementing the conclusions reached; and not releasing the report until the matter is resolved	JB 6/30/XX	Engagement files
Policy 8. Evaluating all engagements against my criteria for an engagement quality control review; contracting with a qualified external person to perform the engagement quality control review; and not releasing the report until the review is completed	JB 6/30/XX	Client acceptance files
Monitoring		
Policy 1. Performing monitoring procedures that are sufficiently comprehensive to enable me to assess compliance with all applicable professional standards and the firm's quality control policies and procedures	JB 6/30/XX	Monitoring files
Policy 2. Dealing appropriately with complaints and allegations	JB 6/30/XX	Engagement files
Policy 3. Preparing appropriate documentation to provide evidence of the operation of each element of the firm's system of quality control	JB 6/30/XX	Monitoring files
Policy 4. Retaining documentation of evidence of the operation of the system of quality control for an appropriate period of time	JB 6/30/XX	Monitoring files

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Chapter 5: System of Quality Control for an Alternative Practice Structure

5.01 An alternative practice structure, as referred to in this practice aid, is a nontraditional structure in the practice of public accounting that contains an attest and a nonattest portion. The attest portion is conducted through a firm owned and controlled by CPAs (a *closely aligned CPA firm*). The nonattest portion is conducted through a separate issuer or nonissuer firm owned and controlled by individuals who are not CPAs (a *non-CPA-owned entity*[1]). The non-CPA-owned entity may be an issuer or a nonissurer. Alternative practice structures are described in Interpretation 101-14, "The effect of alternative practice structures on the applicability of independence rules," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .16), which is included as appendix B of this practice aid.

5.02 The quality control policies and procedures established by a closely aligned CPA firm that may or may not perform audit services are illustrated in chapters 2–3, as applicable. Additional quality control policies and procedures relevant to alternative practice structures may be necessary when certain portions of the CPA firm's system of quality control (*a*) reside at the non-CPA-owned entity or (*b*) operate in conjunction with the system of quality control of the non-CPA-owned entity.

5.03 Elements of quality control that might reside in a non-CPA-owned entity include the following:

- Relevant ethical requirements
- Human resources
- Monitoring of relevant ethical requirements and human resources

For example, the non-CPA-owned entity may be responsible for hiring personnel for both firms.

5.04 This chapter describes how Non-CPA-Owned Entity and Closely Aligned CPA Firm, hypothetical firms that are organized in an alternative practice structure, implement incremental quality control policies and procedures to address the previously mentioned elements of quality control that reside at Non-CPA-Owned Entity. Closely Aligned CPA Firm has no issuer clients[2] and implements the policies and procedures described in chapter 2 of this practice aid.

Quality Control Policies and Procedures

5.05 *Policy 1: The top-tier company*[3] *maintains a system of quality control.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Designating a qualified individual to be responsible for the following:
  - — Designing and directing the quality control activities at the top-tier company
  - — Disseminating information to all subsidiaries and affiliated entities, all subsidiaries associated with CPA firms, and all CPA firms closely aligned with company subsidiaries
- Providing all company personnel and indirect superiors[4] with access to the company's quality control policies and procedures

[1] A *non-CPA-owned entity* is an entity that is closely aligned to a CPA firm through common employment; leasing of employees, equipment, or facilities; or other similar arrangements. In addition to one or more professional service subsidiaries or divisions that offer nonattest professional services (for example, tax, personal financial planning, and management consulting), a non-CPA-owned entity may have subsidiaries or divisions such as a bank, insurance company, or broker-dealer.

[2] If the closely aligned CPA firm were to be engaged to perform audit services for an issuer, the non-CPA-owned entity or its affiliated companies might need to revise their quality control policies and procedures to comply with Public Company Accounting Oversight Board (PCAOB) standards and to reflect Securities and Exchange Commission (SEC) requirements applicable to audits of issuers.

[3] The top-tier company is the parent company of the non-CPA-owned entity, which may be an issuer.

[4] Indirect superiors may be involved in regional management of direct superiors; thus, they may need to adhere to requirements.

Relevant Ethical Requirements

5.06 The objective of the relevant ethical requirements element of a system of quality control is to provide the firm with reasonable assurance that the firm and its personnel comply with relevant ethical requirements when discharging professional responsibilities. Relevant ethical requirements include independence, integrity, and objectivity. Closely Aligned CPA Firm satisfies this objective by ensuring that Non-CPA-Owned Entity establishes and maintains the policies and procedures described in paragraphs 5.07–.09.

5.07 *Policy 1: Non-CPA-Owned Entity adheres to applicable relevant ethical requirements such as those in regulations, interpretations, and rules of the AICPA, state CPA societies, state boards of accountancy, state statutes,the GAO, and any other applicable regulators.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Developing policies and procedures to ensure the independence of Closely Aligned CPA Firm as required by the applicable aforementioned regulators. (Non-CPA-Owned Entity is required to be independent only in the context of its alignment with the CPA firm; it does not perform any attest functions, so its independence is not relevant.)
- Designating an officer to be responsible for providing guidance, answering questions, monitoring compliance, and resolving matters concerning independence, integrity, and objectivity of Closely Aligned CPA Firm.
- Determining when consultation with outside sources regarding independence, integrity, and objectivity matters is required.
- Reviewing written representations from *direct superiors* and *indirect superiors*[5] and others as applicable and resolving potential independence, integrity, and objectivity matters.
- Maintaining documentation of the resolution of independence, integrity, and objectivity matters.
- Requiring entity personnel to obtain sufficient training and education to accomplish their responsibilities with respect to independence, integrity, and objectivity.
- Obtaining from Closely Aligned CPA Firm a current list of all entities with which firm personnel are prohibited from having a financial or business relationship.[6]
- Obtaining written representations from personnel of Non-CPA-Owned Entity, upon hire and on an annual basis, stating that they are familiar with and in compliance with Non-CPA-Owned Entity's policies and procedures regarding independence, integrity, and objectivity.

5.08 *Policy 2: Personnel of Non-CPA-Owned Entity are familiar with policies and procedures regarding relevant ethical requirements.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Providing all of its personnel with access to its policies and procedures and guidance materials related to independence, integrity, and objectivity, such as manuals, memoranda, and databases containing professional and regulatory literature
- Advising personnel of Non-CPA-Owned Entity of the financial or other relationships, circumstances, or activities involving either individuals or entities that may be prohibited, as in the following examples:

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[5] *Direct superiors* are defined to include those persons so closely associated with a partner or manager who is a covered member that such persons can directly control the activities of such partner or manager. For this purpose, a person who can directly control is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (for example, through another entity over which the direct superior can exercise significant influence) derive a benefit from that person's activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. *Indirect superiors* are those persons who are one or more levels above direct superiors. Generally, this would start with persons in an organization structure to whom direct superiors report and go up the line from there.

[6] Examples of business relationships prohibited by independence standard-setting bodies such as the AICPA, the Government Accountability Office, and the U.S. Department of Labor because they might impair independence include being an investor in a joint venture with a client that is material or serving as a board member on the board of an audit client.

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- — Business relationships with Closely Aligned CPA Firm's clients or with nonclients that have investor or investee relationships with Closely Aligned CPA Firm's clients
- — Loans to and from Closely Aligned CPA Firm's clients, including loans from Closely Aligned CPA Firm's financial institution clients
- — Family members who are employed by Closely Aligned CPA Firm's clients or who serve as director, officer, manager, or in other audit-sensitive positions with clients of Closely Aligned CPA Firm, including not-for-profit organizations
- — Past due fees from Closely Aligned CPA Firm's clients
- — Services in which the service provider assumes some of the responsibilities of client management
- — Performing certain bookkeeping services for governmental entities that are clients of Closely Aligned CPA Firm
- — Client relationships with Non-CPA-Owned Entity in which Closely Aligned CPA Firm leases employees, facilities, and so on
- — Situations in which personnel of Non-CPA-Owned Entity act as promoters, underwriters, voting trustees, directors, or officers of Closely Aligned CPA Firm's clients
- — Direct and material indirect financial interests in clients of Closely Aligned CPA Firm
- — Material investments by Closely Aligned CPA Firm's clients in Non-CPA-Owned Entity that allow the clients to exercise significant influence over Non-CPA-Owned Entity

- Advising personnel of Non-CPA-Owned Entity of the following:
  - — All direct superiors with whom, and all activities in which, Non-CPA-Owned Entity is prohibited from engaging, as defined in Non-CPA-Owned Entity's independence policies and procedures
  - — All indirect superiors with whom, and all activities in which, Non-CPA-Owned Entity is prohibited from engaging, as defined by Non-CPA-Owned Entity's policies and procedures
- Obtaining client lists from Closely Aligned CPA Firm to inform all personnel, on a timely basis, of Closely Aligned CPA Firm client's to which independence policies apply
- Obtaining documented representations from all Non-CPA-Owned Entity personnel (including those defined as direct and indirect superiors or supervisors of affiliated issuers),[7] upon hire and on an annual basis thereafter, stating that they are familiar with and in compliance with policies and procedures regarding relevant ethical requirements

5.09 *Policy 3: Non-CPA-Owned Entity identifies and evaluates possible threats to independence and objectivity and takes appropriate action to eliminate those threats or reduce them to an appropriate level by applying safeguards.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Assigning responsibility for obtaining, maintaining, and reviewing documented representations from all Non-CPA-Owned Entity personnel (see paragraph 5.08) for completeness and resolving reported exceptions with Non-CPA-Owned Entity's chief executive
- Requiring the chief executive of Non-CPA-Owned Entity to review or to designate an appropriate individual to review unpaid fees from clients of Closely Aligned CPA Firm to ascertain whether any outstanding amounts impair Closely Aligned CPA Firm's independence
- Requiring all professionals to report, on a timely basis when identified, circumstances and relationships that form a threat to independence so that appropriate action can be taken

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[7] Affiliated issuers include the top-tier company and all entities consolidated in the top-tier company's financial statements. Individuals in these entities are not in situations in which a direct superior can exercise significant influence.

- Requiring all professionals to report, on a timely basis when identified, apparent violations of independence, integrity, or objectivity policies involving themselves, their spouses, or their dependents and the corrective actions taken or proposed to be taken

Human Resources

5.10 The objective of the human resources element of a system of quality control is to provide the firm with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary (*a*) to perform its engagements in accordance with professional standards and regulatory and legal requirements and (*b*) to enable the firm to issue reports that are appropriate in the circumstances. Closely Aligned CPA Firm satisfies this objective by ensuring that Non-CPA-Owned Entity establishes and maintains the policies and procedures comparable to those that are described in paragraphs 5.11–.13 with regard to its leased or per-diem personnel.

5.11 *Policy 1: Leased or per-diem personnel possess characteristics that enable them to competently perform and review engagements.* Non-CPA-Owned Entity implements this policy by having knowledge and experience equivalent to that of Closely Aligned CPA Firm to make the following decisions:

- Designating an individual from Closely Aligned CPA Firm to be responsible for hiring and managing human resources within Non-CPA-Owned Entity on behalf of Closely Aligned CPA Firm.
- Reviewing Closely Aligned CPA Firm's personnel requirements for attest engagements to ensure that sufficient and capable staff persons are available to perform those engagements.
- Involving members of Closely Aligned CPA Firm in the process of hiring professionals on behalf of Closely Aligned CPA Firm that include establishing the attributes, achievements, and experiences desired in entry-level and experienced personnel. Such criteria assist in evaluating (*a*) the personal characteristics of professionals, such as integrity, competence, and motivation, and (*b*) whether professionals can competently perform responsibilities within Closely Aligned CPA Firm.
- Establishing guidelines for additional procedures to be performed when hiring experienced personnel, such as performing background checks and inquiring about any outstanding regulatory actions.
- Establishing criteria for determining which individuals will be involved in interviewing and hiring personnel on behalf of Closely Aligned CPA Firm.

5.12 *Policy 2: Leased or per-diem personnel participate in general and industry-specific continuing professional education (CPE) and other professional activities that enable them to accomplish assigned responsibilities and satisfy applicable CPE requirements of the AICPA, state CPA societies, state accountancy boards, and other regulatory agencies.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Designating an individual to be responsible for CPE and professional development activities, including maintaining appropriate documentation evidencing that leased and per-diem personnel have met the professional education requirements of the AICPA, state boards of accountancy, and other applicable regulators
- Establishing policies that require individuals performing audits, reviews, compilations, or attestation engagements for Closely Aligned CPA Firm to participate in CPE related to accounting and auditing
- Establishing policies requiring all leased or per-diem personnel to be in compliance with the professional education requirements of the boards of accountancy in states where they are licensed and with the AICPA, state societies, and other regulatory agencies, as applicable
- Establishing an orientation and training policy for new hires who will perform audits, reviews, compilations, or attestation engagements for Closely Aligned CPA Firm or who will have partner- or manager-level responsibility for the overall supervision or review of such engagements

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- Ensuring that leased or per-diem personnel are informed about changes in accounting and auditing standards, independence, integrity, and objectivity requirements, and Closely Aligned CPA Firm's technical policies and procedures that are relevant to them
- Encouraging leased or per-diem personnel to participate in other professional activities, such as graduate-level courses, membership in professional organizations, and serving on professional committees

5.13 *Policy 3: Leased or per-diem personnel who are selected for advancement have the qualifications to accomplish the responsibilities they will be called upon to assume. Factors to consider include the degree of technical training and proficiency required in the circumstances and the nature and extent of supervision of assignments relating to audits, reviews, compilations, or attestation engagements performed by Closely Aligned CPA Firm.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Establishing a system for providing information to Closely Aligned CPA Firm so that it can make appropriate personnel decisions, such as assignments for audits, reviews, compilations, and attestation engagements.
- Designating an individual to be responsible for the following:
  - Establishing criteria for the evaluation and advancement of leased or per-diem personnel, including appropriate documentation
  - Making advancement and termination decisions, including identifying responsibilities and requirements for evaluation, at each professional level and deciding who will prepare those evaluations
  - Developing appropriate evaluation forms
  - Reviewing performance evaluations with personnel, discussing future objectives of Closely Aligned CPA Firm and the individual, and discussing assignment preferences
  - Periodically evaluating owners of Closely Aligned CPA Firm by means of peer evaluation or self-appraisal
  - Counseling leased or per-diem personnel regarding their progress and career opportunities
- Establishing an arrangement with Closely Aligned CPA Firm in which a supervisory-level individual of Closely Aligned CPA Firm is responsible for assisting Non-CPA-Owned Entity in making advancement and termination decisions concerning leased or per-diem personnel. This would include evaluating personnel needs, establishing hiring objectives, and providing final approval.
- Developing a system for evaluating the performance of leased or per-diem personnel and advising them of their progress.

Monitoring

5.14 The objective of the monitoring element of a system of quality control is to provide the firm and its engagement partners with reasonable assurance that the policies and procedures related to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Monitoring involves an ongoing consideration and evaluation of the appropriateness of the design, the effectiveness of the operation of a firm's quality control system, and a firm's compliance with its quality control policies and procedures. The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of the following:

- Adherence to professional standards and regulatory and legal requirements
- Whether the quality control system has been appropriately designed and effectively implemented
- Whether the firm's quality control policies and procedures have been operating effectively so that reports that are issued by the CPA firm are appropriate in the circumstances

5.15 A CPA firm that is closely aligned with a non-CPA-owned entity satisfies this objective by ensuring that the non-CPA-owned entity establishes and maintains the policies and procedures described in paragraphs 5.16–.19.

5.16 *Policy 1: Non-CPA-Owned Entity considers and evaluates, on an ongoing basis, the relevance and adequacy of its policies and procedures related to relevant ethical requirements that are applicable to all its personnel and its personnel management policies and procedures that are applicable to leased or per-diem personnel.* Non-CPA-Owned Entity implements this policy by designating qualified individuals to be responsible for monitoring quality assurance, including ensuring that Non-CPA-Owned Entity's quality control guidance is regularly updated to reflect changes in professional standards related to independence, CPE, and other regulatory requirements through the following procedures:

- Implementing a system of ongoing monitoring of the effectiveness and appropriateness of policies and procedures related to independence, objectivity, and integrity as applicable to all personnel of Non-CPA-Owned Entity and compliance with those policies and procedures
- Ensuring, on an ongoing basis, that guidance materials and any practice aids Non-CPA-Owned Entity provides to Closely Aligned CPA Firm are appropriately designed to assist Closely Aligned CPA Firm in adhering to quality control standards
- Maintaining a system to ensure that the practice aids regarding independence and other technical matters provided by Non-CPA-Owned Entity are updated to reflect current professional standards and regulatory requirements and are relevant to and effective for Closely Aligned CPA Firm's practice
- Ensuring that Non-CPA-Owned Entity informs and provides guidance to leased or per-diem personnel regarding new professional standards, regulatory requirements, and related changes to relevant Closely Aligned CPA Firm policies or practice aids

5.17 *Policy 2: Non-CPA-Owned Entity considers and evaluates, on an ongoing basis, compliance with its policies and procedures related to relevant ethical requirements that are applicable to all of its personnel and personnel management policies and procedures that are applicable to leased or per-diem personnel.* Non-CPA-Owned Entity implements this policy by considering and evaluating, on an ongoing basis, compliance with policies and procedures related to independence, integrity, and objectivity, as applicable to all of its personnel, through the following procedures:

- Performing timely monitoring of policies and procedures, on an ongoing basis, related to independence, integrity, and objectivity to evaluate compliance with those policies and procedures. The monitoring policies and procedures could include an internal audit function, ongoing review by senior management, or engaging an independent CPA to examine and report on compliance.
- Summarizing and communicating the results of the monitoring to all of its personnel and communicating any suggested changes to policies and procedures to the appropriate levels of personnel in Non-CPA-Owned Entity.
- Correcting noted deficiencies based on the results of the monitoring to ensure compliance with policies and procedures.

5.18 *Policy 3: Non-CPA-Owned Entity deals appropriately with complaints and allegations.* Non-CPA-Owned Entity implements this policy through the following procedures:

- Performing timely monitoring of policies and procedures, on an ongoing basis, related to independence, integrity, and objectivity to evaluate compliance with those policies and procedures. The monitoring policies and procedures could include an internal audit function, ongoing review by senior management, or engaging an independent CPA to examine and report on compliance.
- Having the firm's ethics committee (excluding any members who are otherwise involved in the engagement under investigation) investigate the following:

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- Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements
- Allegations of noncompliance with the firm's system of quality control
- Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations

- Documenting complaints and allegations and the responses to them.

5.19 *Policy 4: Non-CPA-Owned Entity prepares appropriate documentation to provide evidence of the operation of each element of its system of quality control.* Non-CPA-Owned Entity implements this policy by preparing and retaining documentation that provides evidence of the operation of the system of quality control for a period of time sufficient to permit those performing monitoring procedures to evaluate the firm's compliance with its system of quality control.

Appendix A: Statement on Quality Control Standards (SQCS) No. 7, *A Firm's System of Quality Control*[*]

Supersedes SQCSs Nos. 2–6. SQCS No. 1 was previously superseded by SQCS No. 2.

Source: SQCS No. 7.

Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009.

Statements on Quality Control Standards (SQCS) are issued by the Auditing Standards Board. Firms that are enrolled in an Institute-approved practice-monitoring program are obligated to adhere to quality control standards established by the Institute.

On July 30, 2002, President Bush signed the Sarbanes-Oxley Act of 2002 (Act) which created a five-member Public Company Accounting Oversight Board (PCAOB) and charged it with overseeing audits of issuers, as defined by the Act, or other entities subject to SEC regulation (issuers). Under the Act, the PCAOB's duties include, among other things, establishing auditing, quality control, ethics, independence, and other Standards relating to audits of issuers.

The AICPA's Quality Control Standards do not address the quality-control ramifications of the Act nor do they address the quality control ramifications of PCAOB Standards that must be followed by auditors of issuers. The AICPA's Quality Control Standards do not purport to include any modifications that may be necessary for a firm's system of quality control to conform to PCAOB Standards. Additional information about the PCAOB and the Act can be obtained at the PCAOB website, www.pcaobus.org, and the AICPA website, www.aicpa.org/INTERESTAREAS/CENTERFORAUDITQUALITY/RESOURCES/PCAOB/Pages/PCAOB.aspx.

Introduction

.01 The purpose of this section is to establish standards and provide guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. This section describes elements of quality control and other matters essential to the effective design, implementation, and maintenance of the system. This section is to be read in conjunction with the AICPA Code of Professional Conduct.

.02 This section also sets forth the meaning of certain terms used in SQCSs issued by the Auditing Standards Board in describing the professional requirements imposed on firms and engagement partners.

System of Quality Control

.03 The firm must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements, and that the firm or engagement partners issue reports that are appropriate in the

[*] Resulting from its Clarity Project, the Auditing Standards Board (ASB), in November 2010, issued Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control* (Redrafted) (AICPA, *Professional Standards*, QC sec. 10). SQCS No. 8 does not change or expand the requirements and guidance contained in SQCS No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), in any significant respect.

An executive summary of SQCS No. 8 can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/DownloadableDocuments/RecentlyIssuedSQCSs/SQCS_8_Summary.pdf.

Additional information on the ASB's Clarity Project can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx.

The provisions of SQCS No. 8 are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

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circumstances. A system of quality control consists of policies designed to achieve these objectives and the procedures necessary to implement and monitor compliance with those policies.

.04 The nature of the policies and procedures developed by individual firms to comply with this section will depend on various factors such as the size and operating characteristics of the firm. The system of quality control should be designed to provide the firm with reasonable assurance that the segments of the firm's engagements performed by its foreign member firms or offices or by its domestic or foreign affiliates,if any, are performed in accordance with professional standards in the United States when such standards are applicable.

Definitions

.05 In this section, the following terms have the meanings given:

a. *Accounting and auditing practice.* A practice that performs engagements covered by this section, which are audit, attestation, compilation, review and any other services for which standards have been established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rules 201 or 202 of the AICPA Code of Professional Conduct (ET sections 201–202). Although standards for other engagements may be established by other AICPA technical committees, engagements performed in accordance with those standards are not encompassed in the definition of an accounting and auditing practice.

b. *Engagement documentation.* The record of work performed, results obtained, and conclusions the practitioner reached, also known as *working papers* or *workpapers*.

c. *Engagement partner.* An individual responsible for supervising engagements covered by this section and signing or authorizing an individual to sign the report on such engagements, and who, where required, has the appropriate authority from a professional, legal or regulatory body. Firms may use different titles to refer to individuals with this authority.

d. *Engagement quality control review.* A process designed to provide an objective evaluation, by an individual or individuals who are not members of the engagement team, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.

e. *Engagement quality control reviewer.* A partner, other person in the firm, qualified external person, or a team made up of such individuals, none of whom is part of the engagement team, with sufficient and appropriate experience and authority to perform the engagement quality control review.

f. *Engagement team.* All personnel performing the engagement, excluding those who perform the engagement quality control review. The engagement team (i) includes all employees and contractors retained by the firm who perform engagement procedures, irrespective of their functional classification (for example, audit, tax, or management consulting services) and (ii) excludes specialists as discussed in AU section 336, *Using the Work of a Specialist*, and individuals who perform only routine clerical functions, such as word processing and photocopying.

g. *Firm.* A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the American Institute of Certified Public Accountants that is engaged in the practice of public accounting.

h. *Inspection*. A retrospective evaluation of the adequacy of the firm's quality control policies and procedures, its personnel's understanding of those policies and procedures and the extent of the firm's compliance with them. Inspection is an element of monitoring.

i. *Monitoring*. A process comprising an ongoing consideration and evaluation of the firm's system of quality control, the objective of which is to enable the firm to obtain reasonable assurance that its system of quality control is designed appropriately and operating effectively.

j. *Partner.* An individual with authority to bind the firm with respect to the performance of a professional services engagement. For purposes of this definition, partner may include an employee with this authority who has not assumed the risks and benefits of ownership. Firms may use different titles to refer to individuals with this authority.

k. *Personnel*. All individuals who perform professional services for which the firm is responsible, whether or not they are CPAs.

l. *Professional standards*. Standards established by the AICPA Auditing Standards Board or the AICPA Accounting and Review Services Committee under Rules 201 or 202 of the AICPA Code of Professional Conduct or other standard setting bodies that set auditing and attest standards applicable to the engagement being performed.

m. *Qualified external person.* An individual outside the firm with the capabilities and competence to act as an engagement partner.

n. *Reasonable assurance.* In the context of this standard, a high, but not absolute, level of assurance.

o. *Relevant ethical requirements*. Ethical requirements to which the firm and its personnel are subject, which consist of the AICPA Code of Professional Conduct together with rules of state boards of accountancy and applicable regulatory agencies, which may be more restrictive.

p. *Staff.* Personnel, other than partners and engagement partners, including any specialists who are employees of the firm.

Professional Requirements

.06 SQCSs contain professional requirements together with related guidance in the form of explanatory material. Firms have a responsibility to consider the entire text of an SQCS with regard to their system of quality control and in understanding and applying the professional requirements of the relevant SQCSs.

.07 Not every paragraph of an SQCS carries a professional requirement that the firm is expected to fulfill. Rather, the professional requirements are communicated by the language and the meaning of the words used in the SQCSs.

.08 SQCSs use two categories of professional requirements, identified by specific terms, to describe the degree of responsibility they impose on firms, as follows:

- *Unconditional requirements.* The firm is required to comply with an unconditional requirement in all cases in which the circumstances exist to which the unconditional requirement applies. SQCSs use the words *must* or *is required* to indicate an unconditional requirement.
- *Presumptively mandatory requirements.* The firm is also required to comply with a presumptively mandatory requirement in all cases in which the circumstances exist to which the presumptively mandatory requirement applies; however, in rare circumstances, the firm may depart from a presumptively mandatory requirement provided the practitioner documents his or her justification for the departure and how the alternative procedures performed in the circumstances were sufficient to achieve the objectives of the presumptively mandatory requirement. SQCSs use the word *should* to indicate a presumptively mandatory requirement.

If an SQCS provides that a procedure or action is one that the firm "should consider," the consideration of the procedure or action is presumptively required, whereas carrying out the procedure or action is not. The professional requirements of an SQCS are to be understood and applied in the context of the explanatory material that provides guidance for their application.

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Explanatory Material

.09 Explanatory material is defined as the text within an SQCS (excluding any related interpretations[1]) that may:

- Provide further explanation and guidance on the professional requirements; or
- Identify and describe other procedures or actions relating to the activities of the firm.

.10 Explanatory material that provides further explanation and guidance on the professional requirements is intended to be descriptive rather than imperative. That is, it explains the objective of the professional requirements (where not otherwise self-evident); it explains why the firm might consider or employ particular procedures, depending on the circumstances; and it provides additional information for the firm to consider in exercising professional judgment with regard to its system of quality control.

.11 Explanatory material that identifies and describes other procedures or actions relating to the activities of the firm is not intended to impose a professional requirement for the firm to perform the suggested procedures or actions. Rather, these procedures or actions require the firm's attention and understanding; how and whether the firm carries out such procedures or actions with regard to its system of quality control depends on the exercise of professional judgment in the circumstances consistent with the objective of the standard. The words *may*, *might*, and *could* are used to describe these actions and procedures.

Documentation and Communication of Quality Control Policies and Procedures

.12 The firm should document its quality control policies and procedures. The size, structure, and nature of the practice of the firm are important considerations in determining the extent of the documentation of established quality control policies and procedures. For example, documentation of established quality control policies and procedures would generally be expected to be more extensive in a large firm than in a small firm and in a multioffice firm than in a single-office firm.

.13 The firm should communicate its quality control policies and procedures to its personnel. Although communication is enhanced if it is in writing, the communication of quality control policies and procedures is not required to be in writing. Effective communication of the firm's quality control policies and procedures:

- Describes the quality control policies and procedures and the objectives they are designed to achieve;
- Includes the message that each individual has a personal responsibility for quality and is expected to be familiar with and to comply with these policies and procedures; and
- Stresses the importance of obtaining feedback on its system of quality control from its personnel and encourages its personnel to communicate their views or concerns on quality control matters.

Elements of a System of Quality Control

.14 The firm's system of quality control should include policies and procedures addressing each of the following elements:

a. Leadership responsibilities for quality within the firm (the "tone at the top")

b. Relevant ethical requirements

c. Acceptance and continuance of client relationships and specific engagements

[1] Interpretive publications differ from explanatory material. Interpretive publications, for example, interpretations of the SQCSs, reside outside of the standards section of an SQCS and are recommendations on the application of the SQCS in specific circumstances. In contrast, explanatory material is always contained within the standards sections of the SQCS and is meant to be more descriptive in nature.

d. Human resources

e. Engagement performance

f. Monitoring

Leadership Responsibilities for Quality Within the Firm (the "Tone at the Top")

.15 The firm should promote an internal culture based on the recognition that quality is essential in performing engagements and should establish policies and procedures to support that culture. Such policies and procedures should require the firm's leadership (managing partner or board of managing partners, chief executive officer, or equivalent) to assume ultimate responsibility for the firm's system of quality control.

.16 The firm's leadership and the examples it sets significantly influence the internal culture of the firm. The promotion of a quality-oriented internal culture depends on clear, consistent, and frequent actions and messages from all levels of the firm's management that emphasize the firm's quality control policies and procedures, and the requirement to:

a. Perform work that complies with professional standards and regulatory and legal requirements.

b. Issue reports that are appropriate in the circumstances.

Such actions and messages encourage a culture that recognizes and rewards quality work. These actions and messages may be communicated by training seminars, meetings, formal or informal dialogue, mission statements, newsletters, or briefing memoranda. They may be incorporated in the firm's internal documentation and training materials, and in partner and staff appraisal procedures such that they will support and reinforce the firm's view on the importance of quality and how, practically, it is to be achieved.

.17 Of particular importance in promoting an internal culture based on quality is the need for the firm's leadership to recognize that the firm's business strategy is subject to the overarching requirement for the firm to achieve the objectives of the system of quality control in all the engagements that the firm performs. Accordingly, the firm should establish policies to:

a. Assign management responsibilities so that commercial considerations do not override the quality of work performed;

b. Address performance evaluation, compensation, and advancement (including incentive systems) with regard to its personnel, to demonstrate the firm's overarching commitment to the objectives of the system of quality control; and

c. Devote sufficient and appropriate resources for the development, communication, and support of its quality control policies and procedures.

.18 Any person or persons assigned operational responsibility for the firm's quality control system by the firm's leadership should have sufficient and appropriate experience and ability to identify and understand quality control issues and to develop appropriate policies and procedures, as well as the necessary authority to implement those policies and procedures.

Relevant Ethical Requirements

.19 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

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.20 The AICPA Code of Professional Conduct establishes the fundamental principles of professional ethics, which include:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence
- Due care
- Scope and nature of services

.21 The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and, where applicable, others subject to independence requirements, maintain independence where required. Independence requirements are set forth in Rule 101 (ET section 101) and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Guidance on threats to independence, including the familiarity threat that may be created by using the same senior personnel on an audit or attest engagement over a long period of time, and safeguards to mitigate such threats involving matters that are not explicitly addressed in the Code of Professional Conduct, are set forth in the AICPA's Conceptual Framework for AICPA Independence Standards. Such policies and procedures should enable the firm to:

a. Communicate its independence requirements to its personnel and, where applicable, others subject to them.

b. Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if effective safeguards cannot be applied, withdrawing from the engagement.[2]

.22 Such policies and procedures should require:

a. The engagement partner to consider relevant information about client engagements, including the scope of services, to enable him or her to evaluate the overall effect, if any, on independence requirements.

b. Personnel to promptly notify the engagement partner and the firm of circumstances and relationships that create a threat to independence so that appropriate action can be taken.

c. The accumulation and communication of relevant information to appropriate personnel so that:

i. The firm, the engagement partner, and other firm personnel can readily determine whether they satisfy independence requirements;

ii. The firm can maintain and update information relating to independence; and

iii. The firm and the engagement partner can take appropriate action regarding identified threats to independence.

.23 The firm should establish policies and procedures designed to provide it with reasonable assurance that it is notified of breaches of independence requirements, and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:

a. Personnel to promptly notify the firm of independence breaches of which they become aware.

b. The firm to promptly communicate identified breaches of these policies and procedures and the required corrective actions to:

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[2] An accountant is not precluded from issuing a report with respect to a compilation of financial statements for an entity with respect to which the accountant is not independent. If the accountant is not independent, disclosure of the accountant's lack of independence is the appropriate response.

i. The engagement partner who, with the firm, has the responsibility to address the breach; and

ii. Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action.

c. Confirmation to the firm by the engagement partner and the other individuals referred to in subparagraph b.(ii) that the required corrective actions have been taken.

.24 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the requirements set forth in Rule 101 and its related interpretations and rulings of the AICPA Code of Professional Conduct and the rules of state boards of accountancy and applicable regulatory agencies. Written confirmation may be in paper or electronic form.

.25 The purpose of obtaining confirmation and taking appropriate action on information indicating noncompliance is to demonstrate the importance that the firm attaches to independence and keep the issue current for and visible to its personnel.

.26 For all audit or attestation engagements where regulatory or other authorities require the rotation of personnel after a specified period, the firm's policies and procedures should address these requirements.

Acceptance and Continuance of Client Relationships and Specific Engagements

.27 The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where the firm:

a. Has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties, and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;

b. Is competent to perform the engagement and has the capabilities and resources to do so; and

c. Can comply with legal and ethical requirements.

The firm should obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

.28 To minimize the risk of misunderstandings regarding the nature, scope, and limitations of the services to be performed, policies and procedures should provide for obtaining an understanding with the client regarding those services. Professional standards may provide guidance in deciding whether the understanding should be oral or written.

.29 When issues have been identified, and the firm has decided to accept or continue the client relationship or a specific engagement, the firm should document how the issues were resolved.

.30 Factors to consider regarding the integrity of a client include:

- The nature of the client's operations, including its business practices.
- Information concerning the attitude of the client's principal owners, key management, and those charged with its governance toward such matters as aggressive interpretation of accounting standards and internal control over financial reporting.

The extent of knowledge a firm will have regarding the integrity of a client will generally grow within the context of an ongoing relationship with that client.

.31 Matters to consider in accepting or continuing the client engagement include whether:

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- Firm personnel have knowledge of relevant industries or subject matters or the ability to effectively gain the necessary knowledge;
- Firm personnel have experience with relevant regulatory or reporting requirements, or the ability to effectively gain the necessary competencies;
- The firm has sufficient personnel with the necessary capabilities and competence;
- Specialists are available, if needed;
- Individuals meeting the criteria and eligibility requirements to perform an engagement quality control review are available, where applicable; and
- The firm is able to complete the engagement within the reporting deadline.

.32 If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm should determine whether it is appropriate to accept the engagement. Where the engagement is accepted, the firm should consider any ethical requirements that exist under AICPA Interpretation No. 102-2, "Conflicts of Interest," under Rule 102, *Integrity and Objectivity* (ET section 102), such as disclosure of the relationship to the client and other appropriate parties.

.33 Deciding whether to continue a client relationship includes consideration of significant issues that have arisen during the current or previous engagements, and their implications for continuing the relationship.

.34 If the firm obtains information that would have caused it to decline an engagement if that information had been available earlier, policies and procedures on the continuance of the engagement and the client relationship should include consideration of the professional and legal responsibilities that apply to the circumstances, and the possibility of withdrawing from the engagement or from both the engagement and the client relationship.

.35 Policies and procedures on withdrawal from an engagement or from both the engagement and the client relationship should include documenting significant issues, consultations, conclusions, and the basis for the conclusions. Policies and procedures may include:

- Discussing with the appropriate level of the client's management and those charged with its governance the appropriate action that the firm might take based on the relevant facts and circumstances.
- Considering whether there is a professional, regulatory, or legal requirement for the firm to remain in place, or for the firm to report the withdrawal from the engagement or from both the engagement and the client relationship, together with the reasons for the withdrawal, to regulatory authorities.
- If the firm determines that it is appropriate to withdraw, discussing with the appropriate level of the client's management and those charged with its governance withdrawal from the engagement or from both the engagement and the client relationship.

.36 In certain situations, the auditor may be appointed by statutory procedures or required by law or regulation to perform the engagement. Accordingly, certain of the considerations regarding the acceptance and continuance of client relationships and specific engagements, as set out in paragraphs .27–.35, may not be relevant. Nonetheless, establishing policies and procedures as described may provide valuable information to public sector auditors in performing risk assessments and in carrying out reporting responsibilities.

Human Resources

.37 The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to:

a. Perform its engagements in accordance with professional standards and regulatory and legal requirements, and

b. Enable the firm to issue reports that are appropriate in the circumstances.

.38 Such policies and procedures should address the following:

- Recruitment and hiring, if applicable;
- Determining capabilities and competencies;
- Assigning personnel to engagements, if applicable;
- Professional development; and
- Performance evaluation, compensation, and advancement.

Recruitment and Hiring

.39 Effective recruitment processes and procedures help the firm select individuals of integrity, who have the capacity to develop the capabilities and competence necessary to perform the firm's work, and possess the appropriate characteristics to enable them to perform competently. Examples of such characteristics may include meeting minimum academic requirements established by the firm, maturity, integrity, and leadership traits.

Determining Capabilities and Competencies

.40 Capabilities and competencies are the knowledge, skills, and abilities that qualify personnel to perform an engagement covered by this section. Capabilities and competencies are not measured by periods of time because such a quantitative measurement may not accurately reflect the kinds of experiences gained by personnel in any given time period. Accordingly, for purposes of this section, a measure of overall competency is qualitative rather than quantitative.

.41 Capabilities and competence are developed through a variety of methods; for example:

- Professional education
- Continuing professional development, including training
- Work experience
- Mentoring by more experienced staff; for example, other members of the engagement team

Competencies of Engagement Partner

.42 A firm's quality control policies and procedures should provide reasonable assurance that an engagement partner possesses the competencies necessary to fulfill his or her engagement responsibilities.

.43 In most cases, an engagement partner will have gained the necessary competencies through relevant and appropriate experience in engagements covered by this section. In some cases, however, an engagement partner may have obtained the necessary competencies through disciplines other than the practice of public accounting, such as in relevant industry, governmental, and academic positions. When necessary, the experience of the engagement partner may be supplemented by continuing professional education (CPE) and consultation. The following are examples.

- An engagement partner whose recent experience has consisted primarily in providing tax services may acquire the competencies necessary in the circumstances to perform a compilation or review engagement by obtaining relevant CPE.
- An engagement partner whose experience consists of performing review and compilation engagements may be able to obtain the necessary competencies to perform an audit by becoming familiar with the industry in which the client operates, obtaining CPE relating to auditing, using consulting sources during the course of performing the audit engagement, or any combination of these.

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- A person in academia might obtain the necessary competencies to perform engagements covered by this section by (*a*) obtaining specialized knowledge through teaching or authorship of research projects or similar papers and (*b*) performing a rigorous self-study program, or by engaging a consultant to assist on such engagements.

.44 The characteristics of a particular client, industry, and the kind of service being provided determine the nature and extent of competencies established by a firm that are expected of the engagement partner for an engagement. For example:

- The competencies expected of an engagement partner for an engagement to compile financial statements would be different than those expected of a practitioner engaged to review or audit financial statements.
- Supervising engagements and signing or authorizing others to sign reports for clients in certain industries or engagements, such as financial services, governmental, or employee benefit plan engagements, would require different competencies than those expected in performing attest services for clients in other industries.
- The engagement partner for an attestation engagement to examine management's assertion about the effectiveness of an entity's internal control over financial reporting would be expected to have technical proficiency in understanding and evaluating the effectiveness of controls, while an engagement partner for an attestation engagement to examine investment performance statistics would be expected to have different competencies, including an understanding of the subject matter of the underlying assertion.

.45 In practice, the competency requirements necessary for the engagement partner are broad and varied in both their nature and number. Required competencies include the following, as well as other competencies as necessary in the circumstances.

- *Understanding of the role of a system of quality control and the Code of Professional Conduct*. An understanding of the role of a firm's system of quality control and the AICPA's Code of Professional Conduct, both of which play critical roles in assuring the integrity of the various kinds of reports.
- *Understanding of the service to be performed*. An understanding of the performance, supervision, and reporting aspects of the engagement. This understanding is usually gained through actual participation under appropriate supervision in that type of engagement.
- *Technical proficiency*. An understanding of the applicable professional standards including those standards directly related to the industry in which a client operates and the kinds of transactions in which a client engages.
- *Familiarity with the industry*. An understanding of the industry in which a client operates, to the extent required by professional standards applicable to the kind of service being performed. In performing an audit or review of financial statements, this understanding would include an industry's organization and operating characteristics sufficient to identify areas of high or unusual risk associated with an engagement and to evaluate the reasonableness of industry-specific estimates.
- *Professional judgment*. Skills that indicate sound professional judgment. In performing engagements covered by this section, such skills would typically include the ability to exercise professional skepticism and identify areas requiring special consideration including, for example, the evaluation of the reasonableness of estimates and representations made by management and the determination of the kind of report appropriate in the circumstances.
- *Understanding the organization's information technology systems*. A sufficient understanding of how the organization is dependent on or enabled by information technologies and the manner in which the information systems are used to record and maintain financial information, to determine when involvement of an IT professional is necessary for an audit engagement.

Interrelationship of Competencies and Other Elements of a Firm's System of Quality Control

.46 The competencies listed above are interrelated and gaining one particular competency may be related to achieving another. For example, familiarity with the client's industry interrelates with a practitioner's ability to make professional judgments relating to the client.

.47 In establishing policies and procedures related to the nature of competencies needed by the engagement partner for an engagement, a firm may consider the requirements of policies and procedures established for other elements of quality control. For example, a firm might consider its requirements related to engagement performance in determining the nature of competency requirements that describe the degree of technical proficiency necessary in a given set of circumstances.

The Relationship of the Competency Requirement of the Uniform Accountancy Act to the Human Resource Element of Quality Control

.48 CPAs are required to follow the accountancy laws of the individual licensing jurisdictions in the United States that govern the practice of public accounting. These jurisdictions may have adopted, in whole or in part, the Uniform Accountancy Act (UAA), which is a model legislative statute and related administrative rules designed by the AICPA and the National Association of State Boards of Accountancy (NASBA) to provide a uniform approach to the regulation of the accounting profession. The UAA provides that "any individual licensee who is responsible for supervising attest or compilation services and signs or authorizes someone to sign the accountant's report on the financial statements on behalf of the firm shall meet the competency requirements set out in the professional standards for such services." A firm's compliance with this section is intended to enable a practitioner who performs the services described in the preceding sentence on the firm's behalf to meet the competency requirement referred to in the UAA.

Assignment of Engagement Teams

.49 The firm should assign responsibility for each engagement to an engagement partner and should establish policies and procedures requiring that:

a. The identity and role of the engagement partner are communicated to management and those charged with governance;

b. The engagement partner has the appropriate capabilities, competence, authority, and time to perform the role; and

c. The responsibilities of the engagement partner are clearly defined and communicated to that individual.

.50 Policies and procedures may include systems to monitor the workload and availability of engagement partners so as to enable these individuals to have sufficient time to adequately discharge their responsibilities.

.51 The firm should establish policies and procedures to assign appropriate staff with the necessary capabilities, competence, and time to:

a. Perform engagements in accordance with professional standards and regulatory and legal requirements; and

b. Enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

.52 When assigning engagement teams, and in determining the level of supervision required, the firm might consider factors such as the engagement team's:

- Understanding of, and practical experience with, engagements of a similar nature and complexity through appropriate training and participation.
- Understanding of professional standards and regulatory and legal requirements.

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- Technical knowledge and expertise, including knowledge of relevant information technology.
- Knowledge of relevant industries in which the client operates.
- Ability to apply professional judgment.
- Understanding of the firm's quality control policies and procedures.

Generally, as the ability and experience levels of assigned staff increase, the need for direct supervision decreases.

.53 Appropriate teamwork and training assist less experienced members of the engagement team to clearly understand the objectives of the assigned work.

Professional Development

.54 The continuing competence of the firm's personnel depends to a significant extent on an appropriate level of continuing professional development so that personnel maintain their knowledge and capabilities. Effective policies and procedures emphasize the need for all levels of firm personnel to participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned, and to satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies. Effective policies and procedures also place importance on passing the Uniform CPA Examination. The firm may provide the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence. The firm may use an external source that is qualified for that purpose if internal technical and training resources are unavailable, or for any other reason.

Performance Evaluation, Compensation, and Advancement

.55 The firm's policies and procedures should provide that personnel selected for advancement have the qualifications necessary for fulfillment of the responsibilities they will be called on to assume.

.56 Effective performance evaluation, compensation, and advancement procedures give due recognition and reward to the development and maintenance of competence and commitment to ethical principles. Steps a firm may take in developing and maintaining competence and commitment to ethical principles include:

- Making personnel aware of the firm's expectations regarding performance and ethical principles;
- Providing personnel with evaluation of, and counseling on, performance, progress, and career development; and
- Helping personnel understand that their compensation and advancement to positions of greater responsibility depend upon, among other things, performance quality and adherence to ethical principles, and that failure to comply with the firm's policies and procedures may result in disciplinary action.

The size and circumstances of the firm are important considerations in determining the structure of the firm's performance evaluation process. Smaller firms, in particular, may employ less formal methods of evaluating the performance of their personnel.

Engagement Performance

.57 The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are consistently performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issues reports that are appropriate in the circumstances. Required policies and procedures should address:

a. Engagement performance,

b. Supervision responsibilities, and

c. Review responsibilities.

.58 Effective policies and procedures facilitate consistency in the quality of engagement performance. This may be accomplished through written or electronic manuals, software tools or other forms of standardized documentation, and industry- or subject-matter-specific guidance materials. The firm might address, for example:

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work,
- Processes for complying with applicable engagement standards,
- Processes of engagement supervision, staff training, and mentoring,
- Methods of reviewing the work performed, the significant judgments made, and the type of report being issued,
- Appropriate documentation of the work performed and of the timing and extent of the review,
- Appropriate communication of the results of each engagement, and
- Processes to keep all policies and procedures current.

.59 Policies and procedures for engagement supervision might include:

- Tracking the progress of the engagement;
- Considering the capabilities and competence of individual members of the engagement team, whether they have sufficient time to carry out their work, whether they understand their instructions, and whether the work is being carried out in accordance with the planned approach to the engagement;
- Addressing significant issues arising during the engagement, considering their significance, and appropriately modifying the planned approach; and
- Identifying matters for consultation or consideration by more-experienced engagement team members during the engagement.

.60 Review responsibility policies and procedures should be determined on the basis that qualified engagement team members, which may include the engagement partner, review work performed by other team members on a timely basis.

.61 A review may include consideration of whether, for example:

- The work has been performed in accordance with professional standards and regulatory and legal requirements;
- Significant findings and issues have been raised for further consideration;
- Appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- The nature, timing, and extent of work performed is appropriate and without need for revision;
- The work performed supports the conclusions reached and is appropriately documented;
- The evidence obtained is sufficient and appropriate to support the report; and
- The objectives of the engagement procedures have been achieved.

.62 The firm should establish policies and procedures for engagement teams to complete the assembly of final engagement files on a timely basis, as appropriate for the nature of the engagement, after the engagement reports have been released. Professional standards, laws, or regulations may prescribe the time limits by which the assembly of final engagement files for specific types of engagements is to be completed.

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Confidentiality, Safe Custody, Integrity, Accessibility, and Retrievability of Engagement Documentation

.63 The firm should establish policies and procedures designed to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation.

.64 Relevant ethical requirements establish an obligation for the firm's personnel to observe at all times the confidentiality of information contained in engagement documentation, unless specific client authority has been given to disclose information or there is a legal or professional duty to do so. Specific laws or regulations may impose additional obligations on the firm's personnel to maintain client confidentiality, particularly where data of a personal nature are concerned.

.65 Whether engagement documentation is in paper, electronic, or other media, the integrity, accessibility, and retrievability of the underlying data may be compromised if the documentation could be altered, added to, or deleted without the firm's knowledge, or could be permanently lost or damaged. Appropriate and reasonable controls for engagement documentation may include those that:

- Clearly determine when and by whom engagement documentation was prepared or reviewed;
- Protect the integrity of the information at all stages of the engagement, especially when the information is shared within the engagement team or transmitted to other parties via electronic means;
- Prevent unauthorized changes to the engagement documentation; and
- Allow access to the engagement documentation by the engagement team and other authorized parties as necessary to properly discharge their responsibilities.

.66 Controls that the firm may design and implement to maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of engagement documentation may include, for example:

- The use of a password by engagement team members and data encryption to restrict access to electronic engagement documentation to authorized users;
- Appropriate back-up routines for electronic engagement documentation at appropriate stages during the engagement;
- Procedures for properly distributing engagement documentation to the team members at the start of the engagement, processing it during the engagement, and collating it at the end of the engagement; and
- Procedures for restricting access to and enabling proper distribution and confidential storage of hardcopy engagement documentation.

.67 For practical reasons, original paper documentation may be electronically scanned or otherwise copied to another media for inclusion in engagement files. In that case, the firm should establish procedures designed to maintain the integrity, accessibility, and retrievability of the documentation.

.68 These procedures may include, for example:

- Generating scanned copies that reflect the entire content of the original paper documentation, including manual signatures, cross-references and annotations;
- Integrating the scanned copies into the engagement files, including indexing and signing off on the copies as necessary; and
- Enabling the scanned copies to be retrieved and printed as necessary.

There may be legal, regulatory, or other reasons to retain original paper documentation.

Retention of Engagement Documentation

.69 The firm should establish policies and procedures for the retention of engagement documentation for a period sufficient to meet the needs of the firm, professional standards, laws, and regulations.

.70 In determining the needs of the firm for retention of engagement documentation and the period of such retention, the firm may consider the nature of the engagement and the firm's circumstances; for example, whether the engagement documentation is needed to provide a record of matters of continuing significance to future engagements. The retention period may also depend on other factors, such as whether professional standards, laws, or regulations prescribe specific retention periods for certain types of engagements, or whether there are generally accepted retention periods in the absence of specific legal or regulatory requirements.

.71 Procedures that the firm may adopt for retention of engagement documentation include those that:

- Enable the retrieval of and access to the engagement documentation during the retention period, particularly in the case of electronic documentation, as the underlying technology may be upgraded or changed over time.
- Provide, where necessary, a record of changes made to engagement documentation after the assembly of engagement files has been completed.
- Enable authorized external parties to access and review specific engagement documentation for quality control or other purposes.

Consultation

.72 The firm should establish policies and procedures designed to provide it with reasonable assurance that:

a. Consultation takes place when appropriate (for example, when dealing with complex, unusual, unfamiliar, difficult, or contentious issues);

b. Sufficient and appropriate resources are available to enable appropriate consultation to take place;

c. All the relevant facts known to the engagement team are provided to those consulted;

d. The nature and scope of such consultations are documented, and are understood by both the individual seeking consultation and the individual consulted; and

e. The conclusions resulting from such consultations are documented and implemented.

.73 Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have relevant specialized expertise.

.74 Consultation uses appropriate research resources as well as the collective experience and technical expertise of the firm. Consultation helps to promote quality and improves the application of professional judgment. Appropriate recognition of consultation in the firm's policies and procedures helps to promote a culture in which consultation is recognized as a strength and encourages personnel to consult on complex, unusual, unfamiliar, difficult, or contentious issues.

.75 The firm's consultation procedures should provide for consultation with those having appropriate knowledge, seniority, and experience within the firm (or, where applicable, outside the firm) on significant technical, ethical, and other matters, and for appropriate documentation and implementation of conclusions resulting from consultations.

.76 A firm needing to consult externally may take advantage of advisory services provided by other firms, professional and regulatory bodies, or commercial organizations that provide relevant quality control

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services. Before using such services, the firm should evaluate whether the external provider is qualified for that purpose.

.77 Documentation of consultations with other professionals that involve complex, unusual, unfamiliar, difficult, or contentious matters that is sufficiently complete and detailed contributes to an understanding of:

- The issue on which consultation was sought; and
- The results of the consultation, including any decisions made, the basis for those decisions, and how they were implemented.

Differences of Opinion

.78 The firm should establish policies and procedures for dealing with and resolving differences of opinion within the engagement team, with those consulted, and, where applicable, between the engagement partner and the engagement quality control reviewer (including a qualified external person). Such policies and procedures should require that:

a. Conclusions reached be documented and implemented; and

b. The report not be released until the matter is resolved.

.79 Effective procedures encourage identification of differences of opinion at an early stage, provide clear guidelines about the successive steps to be taken thereafter, and require documentation regarding the resolution of the differences and the implementation of the conclusions reached. Procedures to resolve such differences may include consulting with another practitioner or firm, or a professional or regulatory body.

Engagement Quality Control Review

.80 The firm should establish criteria against which all engagements covered by this section are to be evaluated to determine whether an engagement quality control review should be performed.

.81 The firm's policies and procedures should require that if an engagement meets the criteria established, an engagement quality control review be performed for that engagement, and that the review be completed before the report is released.

.82 The firm's policies and procedures should require the engagement partner to remain responsible for the engagement and its performance, notwithstanding involvement of the engagement quality control reviewer.

.83 The structure and nature of the firm's practice are important considerations in establishing criteria to consider when determining which engagements are to be subject to an engagement quality control review. Such criteria may include:

- The nature of the engagement, including the extent to which it involves a matter of public interest;
- The identification of unusual circumstances or risks in an engagement or class of engagements; and
- Whether laws or regulations require an engagement quality control review.

.84 If the firm has no engagements that meet the criteria, paragraphs .85–.99 do not apply.

Nature, Timing, and Extent of the Engagement Quality Control Review

.85 The engagement quality control review procedures should include an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.

.86 The engagement quality control review should include reading the financial statements or other subject matter information and the report and considering whether the report is appropriate.

.87 An engagement quality control review also should include a review of selected engagement documentation relating to the significant judgments the engagement team made and the conclusions they reached, and should include a discussion with the engagement partner regarding significant findings and issues. The extent of the engagement quality control review may depend upon, among other things, the complexity of the engagement and the risk that the report might not be appropriate in the circumstances.

.88 An engagement quality control review may include consideration of the following:

- The engagement team's evaluation of the firm's independence in relation to the specific engagement;
- Whether appropriate consultation has taken place on matters involving differences of opinion or other difficult or contentious matters and the conclusions arising from those consultations; and
- Whether working papers selected for review reflect the work performed in relation to the significant judgments and support the conclusions reached.

.89 Significant judgments made by the engagement team may include, for example:

- Significant risks identified during the engagement and the responses to those risks.
- Judgments made, particularly with respect to materiality and significant risks.
- The significance and disposition of corrected and uncorrected misstatements identified during the engagement.
- The matters to be communicated to management and those charged with governance and, where applicable, other parties such as regulatory bodies.

.90 The firm's policies and procedures should require the engagement quality control reviewer to conduct the review in a timely manner so that significant issues may be promptly resolved to the reviewer's satisfaction before the report is released. The review may be conducted at appropriate stages during the engagement.

.91 When the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the firm's procedures for dealing with differences of opinion apply (see paragraphs .78–.79).

Criteria for the Eligibility of Engagement Quality Control Reviewers

.92 The firm should establish policies and procedures addressing

a. The appointment of engagement quality control reviewers; and

b. The technical qualifications required to perform the role, including the necessary experience and authority.

.93 The firm's policies and procedures on the technical qualifications of engagement quality control reviewers may address the technical expertise, experience, and authority necessary to fulfill the role. What constitutes sufficient and appropriate technical expertise, experience, and authority depends on the circumstances of the engagement.

.94 The firm should establish policies and procedures designed to maintain the objectivity of the engagement quality control reviewer. Such policies and procedures should provide that while the engagement quality control reviewer is not a member of the engagement team, the engagement quality control reviewer should satisfy the independence requirements relating to the engagements reviewed.

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.95 Policies and procedures designed to maintain the objectivity of the engagement quality control reviewer may include a requirement, where practicable, that the engagement quality control reviewer is not selected by the engagement partner, and requirements that the engagement quality control reviewer not:

a. Participate in the performance of the engagement except as discussed in paragraph .96 or

b. Make decisions for the engagement team.

It may not be practicable, in the case of firms with few partners, for the engagement partner not to be involved in selecting the engagement quality control reviewer.

.96 The engagement partner may consult the engagement quality control reviewer at any stage during the engagement, for example, to establish that a judgment made by the engagement partner will be acceptable to the engagement quality control reviewer. Such consultation need not impair the engagement quality control reviewer's eligibility to perform the role. However, when the nature and extent of the consultations become significant, the reviewer's objectivity may be impaired unless both the engagement team and the reviewer are careful to maintain the reviewer's objectivity.

.97 The firm's policies and procedures should provide for the replacement of the engagement quality control reviewer when the reviewer's ability to perform an objective review has been impaired.

.98 Qualified external persons may be contracted when sole practitioners or small firms identify engagements requiring engagement quality control reviews. Alternatively, some sole practitioners or small firms may wish to use other firms to facilitate engagement quality control reviews. When the firm contracts qualified external persons or other firms, the requirements and guidance in paragraphs .85–.97 apply.

Documentation of the Engagement Quality Control Review

.99 The firm should establish policies and procedures that provide for appropriate documentation of the engagement quality control review, including documentation that:

a. The procedures required by the firm's policies on engagement quality control review have been performed;

b. The engagement quality control review has been completed before the report is released; and

c. The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.

Monitoring

.100 The firm should establish policies and procedures designed to provide the firm and its engagement partners with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively, and complied with in practice. Such policies and procedures should:

a. Include an ongoing consideration and evaluation of the firm's system of quality control to determine

(i) The appropriateness of the design and

(ii) The effectiveness of the operation of the system of quality control.

b. Assign responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.

c. Assign performance of monitoring of the firm's system of quality control to qualified individuals.

.101 The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

- Adherence to professional standards and regulatory and legal requirements;
- Whether the quality control system has been appropriately designed and effectively implemented; and
- Whether the firm's quality control policies and procedures have been operating effectively, so that reports that are issued by the firm are appropriate in the circumstances.

The evaluation may identify circumstances that necessitate changes to, or the need to improve compliance with, the firm's policies and procedures to provide the firm with reasonable assurance that its system of quality control is effective.

.102 The firm's policies should require the performance of monitoring procedures that are sufficiently comprehensive to enable the firm to assess compliance with all applicable professional standards and regulatory requirements, and the firm's quality control policies and procedures. Monitoring procedures include:

- Review of selected administrative and personnel records pertaining to the quality control elements.
- Review of engagement working papers, reports, and clients' financial statements.
- Discussions with the firm's personnel.
- Summarization of the findings from the monitoring procedures, at least annually, and consideration of the systemic causes of findings that indicate improvements are needed.
- Determination of any corrective actions to be taken or improvements to be made with respect to the specific engagements reviewed or the firm's quality control policies and procedures.
- Communication of the identified findings to appropriate firm management personnel.
- Consideration of findings by appropriate firm management personnel who should also determine that any actions necessary, including necessary modifications to the quality control system, are taken on a timely basis.

.103 Monitoring procedures also include an assessment of:

- The appropriateness of the firm's guidance materials and any practice aids;
- New developments in professional standards and regulatory and legal requirements, and how they are reflected in the firm's policies and procedures where appropriate;
- Compliance with policies and procedures on independence;
- The effectiveness of continuing professional development, including training;
- Decisions related to acceptance and continuance of client relationships and specific engagements; and
- Firm personnel's understanding of the firm's quality control policies and procedures, and implementation thereof.

.104 Some of the monitoring procedures discussed above may be accomplished through the performance of:

- Engagement quality control review.
- Postissuance review of engagement working papers, reports, and clients' financial statements for selected engagements.
- Inspection procedures.

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.105 The need for and extent of inspection procedures depends in part on the existence and effectiveness of the other monitoring procedures. The nature of inspection procedures varies based on the firm's quality control policies and procedures and the effectiveness and results of other monitoring procedures.

.106 The inspection of a selection of completed engagements may be performed on a cyclical basis. For example, engagements selected for inspection may include at least one engagement for each engagement partner over an inspection cycle that spans three years. The manner in which the inspection cycle is organized, including the timing of selection of individual engagements, depends on many factors, including the following:

- The size of the firm.
- The number and geographical location of offices.
- The results of previous monitoring procedures.
- The degree of authority both personnel and offices have (for example, whether individual offices are authorized to conduct their own inspections or whether only the head office may conduct them).
- The nature and complexity of the firm's practice and organization.
- The risks associated with the firm's clients and specific engagements.

.107 The inspection process involves the selection of individual engagements, some of which may be selected without prior notification to the engagement team. In determining the scope of the inspections, the firm may take into account the scope or conclusions of a peer review or regulatory inspections. (See paragraph .119.)

.108 Inspection procedures with respect to the engagement performance element of a quality control system are particularly appropriate in a firm with more than a limited number of management-level individuals responsible for the conduct of its accounting and auditing practice.

.109 In small firms with a limited number of persons with sufficient and appropriate experience and authority in the firm, monitoring procedures may need to be performed by some of the same individuals who are responsible for compliance with the firm's quality control policies and procedures. This includes postissuance review of engagement working papers, reports, and clients' financial statements by the person with final responsibility for the engagement. To effectively monitor one's own compliance with the firm's policies and procedures, it is necessary that an individual be able to critically review his or her own performance, assess his or her own strengths and weaknesses, and maintain an attitude of continual improvement. Changes in conditions and in the environment within the firm (such as obtaining clients in an industry not previously serviced or significantly changing the size of the firm) may indicate the need to have quality control policies and procedures monitored by another qualified individual.

.110 Having an individual inspect his or her own compliance with a quality control system may be less effective than having such compliance inspected by another qualified individual. When one individual inspects his or her own compliance, the firm has a higher risk that noncompliance with policies and procedures will not be detected. Accordingly, a firm with a limited number of persons with sufficient and appropriate experience and authority in the firm may find it beneficial to engage a qualified individual from outside the firm to perform inspection procedures.

.111 Any system of quality control has inherent limitations that can reduce its effectiveness. Deficiencies in individual engagements covered by this section do not, in and of themselves, indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that its personnel comply with applicable professional standards. The firm should evaluate the effect of deficiencies noted as a result of the monitoring process and determine whether they require prompt corrective action.

.112 Deficiencies identified during the monitoring process may be

a. Instances that do not necessarily indicate that the firm's system of quality control is insufficient to provide it with reasonable assurance that it complies with professional standards and regulatory and legal requirements, and that the reports issued by the firm or engagement partners are appropriate in the circumstances; or

b. Systemic, repetitive or other significant deficiencies that require prompt corrective action.

.113 The firm should communicate to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.

.114 The firm's evaluation of each type of deficiency should result in recommendations for one or more of the following:

a. Taking appropriate remedial action in relation to an individual engagement or member of personnel.

b. The communication of the findings to those responsible for training and professional development.

c. Changes to the quality control policies and procedures.

d. Disciplinary action against those who fail to comply with the policies and procedures of the firm, especially those who do so repeatedly.

.115 When the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement, the firm should determine what further action is appropriate to comply with relevant professional standards and regulatory and legal requirements. The firm may also consider obtaining legal advice.

.116 At least annually, the firm should communicate the results of the monitoring of its quality control system process to relevant engagement partners and other appropriate individuals within the firm, including the firm's leadership. Such communication should enable the firm and these individuals to take prompt and appropriate action where necessary in accordance with their defined roles and responsibilities and provide a basis for them to rely on the firm's system of quality control. Information communicated should include the following:

a. A description of the monitoring procedures performed.

b. The conclusions drawn from the monitoring procedures.

c. Where relevant, a description of systemic, repetitive, or other significant deficiencies and of the actions taken to resolve or amend those deficiencies.

.117 The reporting of identified deficiencies to individuals other than the relevant engagement partner need not include an identification of the specific engagements concerned, unless such identification is necessary for the proper discharge of the responsibilities of the individuals other than the engagement partner.

.118 The firm should establish policies and procedures requiring appropriate documentation of monitoring (see paragraph .125). Appropriate documentation relating to monitoring includes:

a. Monitoring procedures, including the procedure for selecting completed engagements to be inspected;

b. A record of the evaluation of:

(i) Adherence to professional standards and regulatory and legal requirements;

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(ii) Whether the quality control system has been appropriately designed and effectively implemented; and

(iii) Whether the firm's quality control policies and procedures have been operating effectively, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances; and

c. Identification of the deficiencies noted, an evaluation of their effect, and the basis for determining whether and what further action is necessary.

The Relationship of Peer Review to Monitoring

.119 A peer review does not substitute for all monitoring procedures. However, since the objective of a peer review is similar to that of inspection procedures, a firm's quality control policies and procedures may provide that a peer review conducted under standards established by the AICPA may substitute for the inspection of engagement working papers, reports, and clients' financial statements for some or all engagements for the period covered by the peer review.

Complaints and Allegations

.120 The firm should establish policies and procedures designed to provide it with reasonable assurance that it deals appropriately with:

a. Complaints and allegations that the work performed by the firm fails to comply with professional standards and regulatory and legal requirements; and

b. Allegations of noncompliance with the firm's system of quality control; and

c. Deficiencies in the design or operation of the firm's quality control policies and procedures, or noncompliance with the firm's system of quality control by an individual or individuals, as identified during the investigations into complaints and allegations.

.121 As part of this process, the firm should establish clearly defined channels for firm personnel to raise any concerns in a manner that enables them to come forward without fear of reprisals.

.122 Complaints and allegations of noncompliance with the firm's system of quality control (which do not include those that are clearly frivolous) may originate from within or outside the firm. They may be made by firm personnel, clients, state boards of accountancy, other regulators, or other third parties. They may be received by engagement team members or other firm personnel.

.123 The firm should require that investigations of such complaints and allegations in accordance with established policies and procedures be supervised by a person with sufficient and appropriate experience and authority who is not otherwise involved in the engagement. The firm's policies and procedures may require involving legal counsel in the investigation. Small firms and sole practitioners may use the services of a qualified external person or another firm to carry out the investigation.

.124 The firm should establish policies and procedures requiring documentation of complaints and allegations, and the responses to them.

Documentation of Operation of Quality Control Policies and Procedures

.125 The firm should establish policies and procedures requiring appropriate documentation to provide evidence of the operation of each element of its system of quality control.

.126 The form and content of documentation evidencing the operation of each of the elements of the system of quality control is a matter of judgment and depends on a number of factors, including, for example:

- The size of the firm and the number of offices.
- The nature and complexity of the firm's practice and organization.

For example, large firms may use electronic databases to document matters such as independence confirmations, performance evaluations and the results of monitoring inspections. Smaller firms may use more informal methods such as manual notes, checklists, and forms.

.127 The firm should establish policies and procedures that require retention of documentation for a period of time sufficient to permit those performing monitoring procedures and peer review to evaluate the firm's compliance with its system of quality control, or for a longer period if required by law or regulation.

Effective Date

.128 The provisions of this section are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009.

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Appendix B:

Interpretation No. 101-14 of Rule 101

Interpretation No. 101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules"

Because of changes in the manner in which **members**[*] are structuring their practices, the AICPA's professional ethics executive committee (PEEC) studied various alternatives to "traditional structures" to determine whether additional independence requirements are necessary to ensure the protection of the public interest.

In many "nontraditional structures," a substantial (the nonattest) portion of a member's practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm owned and controlled by the member. All such structures must comply with applicable laws, regulations, and Rule 505, *Form of Organization and Name* [ET section 505.01]. In complying with laws, regulations, and rule 505 [ET section 505.01], many elements of quality control are required to ensure that the public interest is adequately protected. For example, all services performed by members and persons over whom they have control must comply with standards promulgated by AICPA Council-designated bodies, and, for all other firms providing attest services, enrollment is required in an AICPA-approved practice-monitoring program. Finally, and importantly, the members are responsible, financially and otherwise, for all the attest work performed. Considering the extent of such measures, PEEC believes that the additional independence rules set forth in this interpretation are sufficient to ensure that attest services can be performed with objectivity and, therefore, the additional rules satisfactorily protect the public interest.

Rule 505 [ET section 505.01] and the following independence rules for an alternative practice structure (APS) are intended to be conceptual and applicable to all structures where the "traditional firm" engaged in attest services is closely aligned with another organization, public or private, that performs other professional services. The following paragraph and the chart below provide an example of a structure in use at the time this interpretation was developed. Many of the references in this interpretation are to the example. PEEC intends that the concepts expressed herein be applied, in spirit and in substance, to variations of the example structure as they develop.

The example APS in this interpretation is one where an existing CPA practice ("Oldfirm") is sold by its owners to another (possibly public) entity ("PublicCo"). PublicCo has subsidiaries or divisions such as a bank, insurance company or broker-dealer, and it also has one or more professional service subsidiaries or divisions that offer to clients nonattest professional services (e.g., tax, personal financial planning, and management consulting). The owners and employees of Oldfirm become employees of one of PublicCo's subsidiaries or divisions and may provide those nonattest services. In addition, the owners of Oldfirm form a new CPA firm ("Newfirm") to provide attest services. CPAs, including the former owners of Oldfirm, own a majority of Newfirm (as to vote and financial interests). Attest services are performed by Newfirm and are supervised by its owners. The arrangement between Newfirm and PublicCo (or one of its subsidiaries or divisions) includes the lease of employees, office space and equipment; the performance of back-office functions such as billing and collections; and advertising. Newfirm pays a negotiated amount for these services.

APS Independence Rules for Covered Members

The term **covered member** in an APS includes both employed and leased individuals. The **firm** in such definition would be Newfirm in the example APS. All covered members, including the firm, are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety. For example, no covered member may have, among other things, a direct financial interest in or a loan to or from an attest client of Newfirm.

Partners of one Newfirm generally would not be considered partners of another Newfirm except in situations where those partners perform services for the other Newfirm or where there are significant shared economic interests between partners of more than one Newfirm. If, for example, partners of Newfirm 1 perform services in Newfirm 2, such owners would be considered to be partners of both Newfirms for purposes of applying the independence rules.

[*] Terms shown in **boldface** type upon first usage in this interpretation are defined in ET section 92, *Definitions*.

APS Independence Rules for Persons and Entities Other Than Covered Members

As stated above, the independence rules normally extend only to those persons and entities included in the definition of covered member. This normally would include only the "traditional firm" (Newfirm in the example APS), those covered members who own or are employed or leased by Newfirm, and entities controlled by one or more of such persons. Because of the close alignment in many APSs between persons and entities included in covered member and other persons and entities, to ensure the protection of the public interest, PEEC believes it appropriate to require restrictions in addition to those required in a traditional firm structure. Those restrictions are divided into two groups:

1. *Direct Superiors.* Direct Superiors are defined to include those persons so closely associated with a partner or manager who is a covered member, that such persons can *directly control* the activities of such partner or manager. For this purpose, a person who can *directly control* is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (e.g. through another entity over which the Direct Superior can exercise significant influence[1]) derive a benefit from that person's activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. This group of persons is, in the view of PEEC, so closely aligned through direct reporting relationships with such persons that their interests would seem to be inseparable. *Consequently, persons considered Direct Superiors, and entities within the APS over which such persons can exercise significant influence[2] are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.*

2. *Indirect Superiors and Other PublicCo Entities.* Indirect Superiors are those persons who are one or more levels above persons included in Direct Superior. Generally, this would start with persons in an organization structure to whom Direct Superiors report and go up the line from there. PEEC believes that certain restrictions must be placed on Indirect Superiors, but also believes that such persons are sufficiently removed from partners and managers who are covered persons to permit a somewhat less restrictive standard. Indirect Superiors are not connected with partners and managers who are covered members through direct reporting relationships; there always is a level in between. The PEEC also believes that, for purposes of the following, the definition of Indirect Superior also includes the **immediate family** of the Indirect Superior.

PEEC carefully considered the risk that an Indirect Superior, through a Direct Superior, might attempt to influence the decisions made during the engagement for a Newfirm attest client. PEEC believes that this risk is reduced to a sufficiently low level by prohibiting certain relationships between Indirect Superiors and Newfirm attest clients and by applying a materiality concept with respect to financial relationships. If the financial relationship is not material to the Indirect Superior, PEEC believes that he or she would not be sufficiently financially motivated to attempt such influence particularly with sufficient effort to overcome the presumed integrity, objectivity and strength of character of individuals involved in the engagement.

[1] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Financial Accounting Standards Board (FASB) *Accounting Standards Codification* (ASC) 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

[2] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in FASB ASC 323-10-15 and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

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Similar standards also are appropriate for Other PublicCo Entities. These entities are defined to include PublicCo and all entities consolidated in the PublicCo financial statements that are not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

The rules for Indirect Superiors and Other PublicCo Entities are as follows:

A. Indirect Superiors and Other PublicCo Entities may *not* have a relationship contemplated by interpretation 101-1.A [ET section 101.02] (e.g., investments, loans, etc.) with an attest client of Newfirm that is material. In making the test for materiality for financial relationships of an Indirect Superior, all the financial relationships with an attest client held by such person should be aggregated and, to determine materiality, assessed in relation to the person's net worth. In making the materiality test for financial relationships of Other PublicCo Entities, all the financial relationships with an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo. In addition, any Other PublicCo Entity over which an Indirect Superior has direct responsibility cannot have a financial relationship with an attest client that is material in relation to the Other PublicCo Entity's financial statements.

B. Further, financial relationships of Indirect Superiors or Other PublicCo Entities should not allow such persons or entities to exercise significant influence[3] over the attest client. In making the test for significant influence, financial relationships of all Indirect Superiors and Other PublicCo Entities should be aggregated.

C. Neither Other PublicCo Entities nor any of their employees may be connected with an attest client of Newfirm as a promoter, underwriter, voting trustee, director or officer.

D. Except as noted in C above, Indirect Superiors and Other PublicCo Entities may provide services to an attest client of Newfirm that would impair independence if performed by Newfirm. For example, trustee and asset custodial services in the ordinary course of business by a bank subsidiary of PublicCo would be acceptable as long as the bank was not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

Other Matters

1. An example, using the chart below, of the application of the concept of Direct and Indirect Superiors would be as follows: The chief executive of the local office of the Professional Services Subsidiary (PSS), where the partners of Newfirm are employed, would be a Direct Superior. The chief executive of PSS itself would be an Indirect Superior, and there may be Indirect Superiors in between such as a regional chief executive of all PSS offices within a geographic area.

2. PEEC has concluded that Newfirm (and its partners and employees) may not perform an **attest engagement** for PublicCo or any of its subsidiaries or divisions.

3. PEEC has concluded that independence would be considered to be impaired with respect to an attest client of Newfirm if such attest client holds an investment in PublicCo that is material to the attest client or allows the attest client to exercise significant influence[4] over PublicCo.

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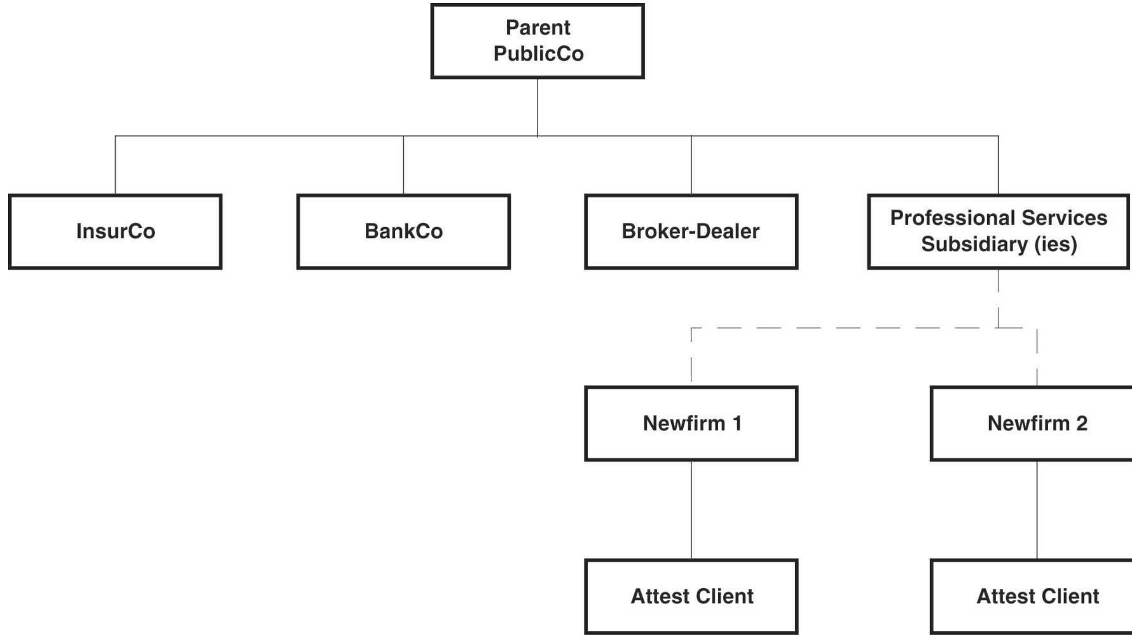
[3] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in FASB ASC 323-10-15 and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

[4] For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in FASB ASC 323-10-15 and its interpretations to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive.

4. When making referrals of services between Newfirm and any of the entities within PublicCo, a member should consider the provisions of Interpretation 102-2, *Conflicts of Interest* [ET section 102.03].

Alternative Practice Structure (APS) Model



[*The next page is 10,261.*]

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AAM Section 10,250

Statement on Quality Control Standards

Statements on Quality Control Standards (SQCSs) are issued by the Auditing Standards Board. Firms that are enrolled in an AICPA approved practice-monitoring program are obligated to adhere to quality control standards established by the AICPA.

Statement on Quality Control Standards No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A)*

Supersedes SQCS Nos. 2–6. SQCS No. 1 was previously superseded by SQCS No. 2.

Effective date: Applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2009.

[*Refer to section 10,200 appendix A for reprint*.]

[*The next page is 10,281.*]

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* Resulting from its Clarity Project, the Auditing Standards Board (ASB), in November 2010, issued Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control* (Redrafted) (AICPA, *Professional Standards*, QC sec. 10). SQCS No. 8 does not change or expand the requirements and guidance contained in SQCS No. 7, *A Firm's System of Quality Control* (AICPA, *Professional Standards*, QC sec. 10A), in any significant respect.

An executive summary of SQCS No. 8 can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/DownloadableDocuments/RecentlyIssuedSQCSs/SQCS_8_Summary.pdf.

Additional information on the ASB's Clarity Project can be found at www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestStndrds/ASBClarity/Pages/ImprovingClarityASBStandards.aspx.

The provisions of SQCS No. 8 are applicable to a CPA firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

AAM Section 10,280

Interpretation No. 101-14 of Rule 101, Independence

Interpretation No. 101-14, "The Effect of Alternative Practice Structures on the Applicability of Independence Rules," under Rule 101, *Independence* (AICPA, *Professional Standards*, ET sec. 101 par. .16)

[*Refer to section 10,200 appendix B for reprint.*]

[*The next page is 10,301.*]

AAM Section 10,300

Sample Quality Control Forms

.01 The following are sample documents and forms that practitioners may find useful.

.02 Independence and Representation Checklist for Other Auditors

Office _________________

Firm name ______________

In order to determine that your firm is in compliance with the independence standards, regulations, interpretations and rulings of the AICPA, the [*name of State*] CPA Society, the [*name of State*] Board of Accountancy, and [*name of State*] statutes the following must be completed by _____ [*date*] and returned to _____ as noted. If there are any questions you have related to the completion of the form, or if there is a matter that has come to your attention which may impair your firm's independence, please contact [*name of Partner*] to resolve the problem.

	Yes	***No***
1. We are aware that [*Name of primary auditor*] has been engaged to audit the financial statements of [*Name of parent*] as of [*Date*] and for the [*period, for example, 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, for example, 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

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.03 Scheduling Request

Client ____________________ Engagement No. __________ Year End __________

Partner ____________________ Manager __________ Tax Ptr/Mgr __________

Personnel Requested	Experience Level	Interim			Year End			Total Hours
		From	Thru	Hours	From	Thru	Hours	

Audited? Yes______ No ______
SEC? Yes______ No ______
Reviewed? Yes______ No ______
Compiled? Yes______ No ______
Attestation? Yes______ No ______

Industry ____________________

Estimated total hours:
Partner ______________
Manager ______________
Staff ______________
Total

Can dates be adjusted? Yes _____ No ______ Explain ______________

Can personnel be changed? Yes _____ No ______ Explain ______________

Comments ____

____

____

Requested by ______________ Date __________ Scheduled __________ Date _______
Assignment Manager

.04 History of Staff Assignments

NAME ______________________________

CLIENT/ LOCATION	DATES		RESPONSIBILITY LEVEL	ASSIGNMENT DESCRIPTION				
	INTERIM	YEAR END		TOTAL HOURS	INDUSTRY	SEC	AUDIT AREAS PERFORMED	REPORTED TO

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.05 Client History of Personnel Assigned

CLIENT ______________________________ LOCATION ____________________

YEAR ENDING ________________ AUDITED? YES ________ NO ________ SEC? YES __________ NO __________

FISCAL YEAR	HOURS		ENTER NAMES AND CHARGEABLE HOURS FOR THE YEAR							
	INTERIM	YEAR END	PARTNER	MANAGER	SENIOR	IN-CHARGE	STAFF	STAFF	STAFF	STAFF

.06 Scheduling Master Plan

MONTH OF ______

			Nonworking hours							Nonrecurring assignments					Hours for month	
Staff member	Carry forward	Month assign-ments	Vacation	Holiday	Prof dev.	Comp time	CPA exam	Admin	Other	Tax dept	Review dept	Other client #	Other hr	Total assign	Avail-able	(Over) under
Aston	XX	XX	XX	X	X		X					XXXXXX	X	XXX	X	XX
Barry	XX	X	XX	X	X			X	X					XXX	XX	X
Casey	X	X	X	X					X	X				XXX	XX	XX
Davis	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	XX	(XX)
Evans	X	X	X	X	X	X						XXXXXXX	XX	XXXX		(XX)
Frank	XX	X	X	X	X	X	X	X	X	X	X	XXXXXXX	XX	XXXX	X	(XX)
Louis	XX	X	XX	X	X	X		X		X				XXX	XX	XX
Miceli	XX	X	XX	XX	X	X	X	X						XXX	XX	XX
Total	XXXX	XX	XXX	XXX	XX	XX	XX	XX	XX	XX	XX		XXX	XXX	XXX	XXX

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.07 Consultation Log

						MEMORANDUM	
DATE	MODE OF COMMUNICATION	CLIENT	OFFICE	REQUEST	RESPONSE	REQUIRED YES/NO	DATE REC'D

.08 Consultation Worksheet

DATE ______________________________

CLIENT NAME ______________________________

LOCATION ______________________________

ENGAGEMENT (TYPE) ______________________________

SUBJECT (QUESTION) ______________________________

____

____

____

____

____

____

____

CONSULTANT'S RESPONSE: (Cite professional literature discussed and conclusion of consultant) ______

____

____

____

FINAL RESOLUTION ______________________________

____

____

____

____

______________________________ ______________________________
Senior/Manager Date

______________________________ ______________________________
Partner Date

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.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 the AICPA *Management of an Accounting Practice Handbook* for an alternative.

EMPLOYMENT HISTORY — ☐ See Below ☐ See Attached Resume   List present (or if currently unemployed, most recent) position first.

FROM	TO	EMPLOYER'S NAME	EMPLOYER'S ADDRESS	POSITION OR TITLE	SUPERVISION	REASON FOR LEAVING

USE THIS SPACE TO ACCOUNT FOR PERIODS NOT WORKED	ADDITIONAL INFORMATION HELPFUL IN CONSIDERING EMPLOYMENT

AGREEMENT

"I certify that the information given by me in this application is true in all respects, and I agree that if employed and it is found to be false in any way, that I may be subject to dismissal without notice, if and when discovered. I authorize the use of any information in this application to enable ________________ to verify my statements, and I authorize ________________, past employers, doctors, all references and any other persons to answer all questions asked by ________________ concerning my ability, character, reputation, and previous employment record. I release all such persons from any liability or damages on account of having furnished such information. I further agree, if employed, that (i) I am to work faithfully and diligently, to be careful and avoid accident, to come to work promptly, and I am not to be absent for any reason without prior notice to my supervisor, (ii) upon termination of employment, ________________ may answer all questions asked of any prospective employer concerning my ability, character, reputation and employment record. I agree to submit to a physical examination whenever requested by ________________ and, if employed, I agree to abide by all present and subsequently issued personnel policies and rules of ____."

APPLICANT'S SIGNATURE: ____ DATE: ________________

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.10 Interview Report

DAY ________________

DATE ______________

TIME _______________

NAME OF APPLICANT ____

POSITION APPLIED FOR ____

COMMENTS BY INTERVIEWER:

RECOMMENDED ACTION:

INTERVIEWED BY: ____________________ TITLE: ____________________

PLEASE RETURN TO HUMAN RESOURCES AS SOON AS POSSIBLE

Note: See the AICPA *Management of an Accounting Practice 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.	________	________	___	________

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.12 20XX Professional Development

Summary *(in hours)*

		In-house presentations			
		Developed in-house	Purchased programs	Outside courses	Total
Partners/Owners					
1.					
2.					
3.					

		In-house presentations			
		Developed in-house	Purchased programs	Outside courses	Total
Professional staff					
1.					
2.					
3.					
4.					
5.					
6.					
7.					
8.					
Paraprofessionals					
1.					
2.					
3.					
4.					

.13 20XX Professional Development

Summary *(in dollars)*

	Purchased programs for in-house use	Outside courses	Total
Partners/Owners			
1. ______	$ ______	$ ______	$ ______
2. ______	______	______	______
3. ______	______	______	______
Professional staff			
1. ______	______	______	______
2. ______	______	______	______
3. ______	______	______	______
4. ______	______	______	______
5. ______	______	______	______
6. ______	______	______	______
7. ______	______	______	______
8. ______	______	______	______
Paraprofessionals			
1. ______	______	______	______
2. ______	______	______	______
3. ______	______	______	______
4. ______	______	______	______

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.14 Performance Evaluation

[To be completed after each engagement of 40 hours or more.]

Name ______________________________ Classification ____________

Client ______________________________ From ________ To ________

Describe work assigned: ______________________________

____

____

In your opinion based on the staff member's classification, should this assignment be considered:

Demanding ☐ Routine ☐

This individual is ☐ is not ☐ ready for increased responsibility. Explain ______________

____

Rating: Enter comments which describe the staff member's performance on this engagement. Rate the staff member on each of the items below as Outstanding (O), Very High (VH), Good (G), Below Normal (BN), or Not Applicable (NA).

[Support each caption with specific incidents or remarks.]

Technical Knowledge: Did the staff member possess adequate knowledge to function effectively at the level assigned? Did this knowledge encompass accounting principles, auditing standards, and tax accounting? Has the staff member kept current on recent developments and new pronouncements on professional practice matters as they affected this engagement?

O VH G BN NA

Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Analytical Ability and Judgment: How well did the staff member recognize problems, develop relevant facts, formulate alternative solutions, and decide on appropriate conclusions? Did the staff member distinguish between material and immaterial items? Was the staff member practical in adapting theory and experience to the individual circumstances of this client?

O VH G BN NA

Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

Written and Oral Expression: Evaluate the effectiveness of the staff member's letters, memoranda, and other forms of written communication. In conversation, did the staff member communicate intentions effectively? Were instructions understood the first time? Did the staff member sell ideas, obtain acceptance and action?

O VH G BN NA

Rating: ☐ ☐ ☐ ☐ ☐

____

____

____

(continued)

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?

Rating: O VH G BN NA
☐ ☐ ☐ ☐ ☐

Development of Personnel: In assigning work, did the in-charge member make the most effective use of available talent in terms of getting the work done and in terms of developing staff members performing the work? Did the in-charge staff member tend to make assignments which were either too easy or too hard for his subordinates? Was the staff member readily accepted as a leader? Was the staff member effective in on-the-job coaching?

Rating: O VH G BN NA
☐ ☐ ☐ ☐ ☐

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?

Rating: O VH G BN NA
☐ ☐ ☐ ☐ ☐

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?

Rating: O VH G BN NA
☐ ☐ ☐ ☐ ☐

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?

Rating: O VH G BN NA
☐ ☐ ☐ ☐ ☐

Note: See the AICPA MAP Handbook for alternatives.

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Strong points which were evident: ____
____
____
____
____

Recommendations for improvement:____
____
____
____
____

Comments of Staff Member Being Evaluated: __________________________________
____
____
____
____

Signatures:

Evaluated staff member ______________________________________ Date __________

Evaluator________________________________ Title ____________ Date __________

Engagement manager ____ Date __________

Partner____ Date __________

.15

JOB EVALUATION REPORT
[For Assignments of Thirty (30) Hours or More]

Name ______________________________

Location ______________________________

Engagement ______________________________

Assistant ______________________________ In-Charge ______________________________

	Compared to Others in Peer Group							
	A	A-	B+	B	B-	C+	C	
	SUPERIOR	EXCELLENT	ABOVE AVERAGE	SATISFACTORY	IMPROVEMENT DESIRED	IMPROVEMENT REQUIRED	UNSATISFACTORY	NOT APPLICABLE
A. PERFORMANCE ON THE JOB								
1. *Technical Ability Demonstrated*								
a) The purpose of the audit procedures planned was understood								
b) Materiality was neither underestimated nor overestimated								
c) Accounting theory and current releases of the profession were applied correctly								
d) Federal and state income tax regulations were applied correctly								
2. *Working Paper Evidence*								
a) Documentation of work performance, including adequate indexing and cross referencing								
b) Sound explanations and conclusions								
c) Use of standard work papers								
d) Legibility								
e) Accuracy — absence of mathematical errors								
3. *Completing This Job*								
a) Meeting planned time estimates								
b) Completing reports and tax returns								
c) Following up the reviewer's comments and making the necessary changes								
4. *Client Reaction on This Job*								
a) Getting along with the client's employees								
b) Interest in the client's business								
B. ENGAGEMENT ADMINISTRATION — (For In-Charge Accountants Only)								
1. *Effectiveness of Proper Planning*								
a) Extent that the scope of the work related to internal control								
b) Developing the work program								
2. *Utilizing Staff Effectively and Efficiently*								
a) Advance planning to minimize crises								
b) Efficient use of staff on the job								
c) On-the-job training of assistants								
3. *Meeting Deadlines*								
a) Completing the engagement in the planned time								
b) Delivering completed pencil copies of the report and tax returns to the supervisor as agreed								
4. *The Product*								
a) Quality of report preparation, including adequate and informative disclosures								
b) Quality of the management advice recommendations								
5. *Practice Management*								
a) Extending service								
b) Ease of collecting for services performed								

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.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				Most
				1	2	3	4	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)

.17 Employee Annual Performance Appraisal

Time Period Involved			
From	To		☐ EXEMPT
			☐ NON-EXEMPT

Name		Position Title	Number
Hire Date	Present Position Date	Days Absent From: ____________ To: ________ Charged To Sick Time: ______________ Disability: ______________	

Strengths	Development Needs
	Suggested Plan for Performance Improvement

Summary

Overall Rating on Having Met Job Requirements	
Non-Exempt - Circle One	Exempt - Circle One
1 2 3	1 2 3 4 5
1 = Did Not Meet Job Requirements	1 = Did Not Meet Job Requirements 2 = Met Most
2 = Met All 3 = Exceeded	3 = Met All 4 = Exceeded 5 = Far Exceeded

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Review the following questions before answering them, using the following criteria:

- A *yes* answer should be considered for possible mention as a "strength." If so, refer to it on the first page of this evaluation.
- A *no* answer should be considered for possible mention as a "development need." If so, refer to it on the first page of this evaluation.

All answers should be considered in arriving at an overall rating on having met job requirements.

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Quality of Work					
Is work accurate, neat, and clearly presented?	( )	( )	( )	( )	( )
Carefully planned, well organized, and thorough?	( )	( )	( )	( )	( )
Productivity					
Is a good level of production maintained?	( )	( )	( )	( )	( )
Are deadlines met?	( )	( )	( )	( )	( )
Are pressure situations handled effectively?	( )	( )	( )	( )	( )
Knowledge of Job					
Does the individual know where to get information?	( )	( )	( )	( )	( )
Is the individual used as a source of information by others?	( )	( )	( )	( )	( )
Communication					
Does the individual ask for clarification when necessary?	( )	( )	( )	( )	( )
Does the individual respond to others in a manner that indicates understanding?	( )	( )	( )	( )	( )
Are ideas expressed so that others are able to understand them?	( )	( )	( )	( )	( )
Human Relations					
Does the individual cooperate with others to get the job done?	( )	( )	( )	( )	( )
Does the individual demonstrate tact and courtesy in dealing with others?	( )	( )	( )	( )	( )
Does the individual maintain a good working relationship with all others?	( )	( )	( )	( )	( )
Are questions and requests dealt with in a helpful manner?	( )	( )	( )	( )	( )
Need for Supervision					
Can the individual be relied upon to get work done without close supervision?	( )	( )	( )	( )	( )
Does the individual take the initiative when appropriate?	( )	( )	( )	( )	( )
Problem Solving					
Does the individual collect the data needed to solve problems?	( )	( )	( )	( )	( )
Are problems solved quickly?	( )	( )	( )	( )	( )

(continued)

	CHECK AS APPROPRIATE				
	Strength	Yes	N/A	No	Development Need
Problem Solving—cont'd					
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 AICPA's established work hours?	( )	( )	( )	( )	( )
Does the individual provide proper notification when absent from work?	( )	( )	( )	( )	( )
Personal Development					
Does the individual try to expand on required knowledge and skills?	( )	( )	( )	( )	( )
Does the individual readily grasp and master the new job requirements?	( )	( )	( )	( )	( )
Does the individual show ambition by building on strengths and working on deficiencies?	( )	( )	( )	( )	( )
Is the individual a good candidate for promotion?	( )	( )	( )	( )	( )
Is the individual ready for promotion at this time?	( )	( )	( )	( )	( )
Supervisory Capabilities					
Does the individual demonstrate the ability to direct and be responsible for the performance of others?	( )	( )	( )	( )	( )
Does the individual effectively evaluate and develop subordinates?	( )	( )	( )	( )	( )
Are subordinates properly motivated?	( )	( )	( )	( )	( )
Are subordinates given reasonable goals and aided in meeting them?	( )	( )	( )	( )	( )
Does the individual comply with administrative and policy guidelines of _________?	( )	( )	( )	( )	( )
Is good judgment exercised in observing budget constraints?	( )	( )	( )	( )	( )
Does the individual maintain adequate discipline in regard to subordinates attendance and punctuality?	( )	( )	( )	( )	( )
Does the individual provide a good example for peers and subordinates to follow?	( )	( )	( )	( )	( )

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INCUMBENT REVIEW COMMENTS & ACKNOWLEDGEMENT
I acknowledge that: (1) I have reviewed and discussed this performance appraisal with the preparer. My signature means that I have been advised of my performance evaluation but does not necessarily imply that I agree with it; (2) I have received a copy of the goals/duties that will be used to evaluate my performance during the coming year; and (3) I have reviewed my job description and do ☐ do not ☐ feel it should be revised. My signature and the date I discussed this with the preparer appears below.

Employee	Date
Evaluator/Title	**Date**

.18 Client/Engagement Acceptance and Continuation Checklist [1]

Note: Acceptance of a new client normally is of critical importance to a small firm. Depending on the type of industry and the services to be provided, accepting a new client can affect nearly all aspects of a firm's quality control system: Are the firm's library and practice aids adequate? Do personnel have appropriate CPE? Does the firm need an outside consultant? The best time to document the acceptance decision is when a new audit or attestation client or engagement is signed, using a form such as the one below.

Name of prospective client: ____________________

Address and Phone No.: ____________________

____

Name and title of contact at prospective client: ____________________

____

Form completed by: ____________________ Date: ____________

Instructions

This form provides for information necessary to assess whether to accept a prospective client. The information should be obtained from discussions with the prospective client's management, bankers, attorneys, credit services, and if applicable current or former independent CPA, from reviewing the client's financial statements, regulatory agency reports, credit reports, and tax returns, and from other sources such as industry or accounting journals, etc. As much information as possible should be obtained before visiting the potential client. Depending on the type of engagement involved, some information requested on this form may not be applicable, or additional information may be necessary and should be attached.

Services and Reports Required

1. Describe the service and reports requested. ____________________

2. Describe the reason the service is needed, including any regulatory requirements or third parties for which the service or report is intended. ____________________

3. What is the required completion date? ____________________

4. Describe any other services not requested for which there appears to be a need. ____________________

5. What is the preliminary estimate of hours to complete the engagement? ____________________

6. Has the client imposed any restrictions on the scope of the engagement that might preclude expression of an unqualified report? ____________________

7. Do we have the necessary expertise and staff to perform the engagement? (If not, how will we overcome this problem?) ____________________

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Industry Practices and Conditions

8. In what industry does the company operate?____
____
9. Describe any specialized tax or accounting practices applicable to the industry.______________
____
____
10. Describe any economic, technological or competitive conditions or other recent developments in the industry that may affect the company's operations. _____________________________________
____
____
11. Describe any special regulatory requirements applicable to the industry. ____________________
____
____
12. Is the company in the development stage? ____
____

Organization and Personnel

13. Company's Legal Name: _________________________________ Fiscal Year End: ___________
14. Type of legal entity (Corporation, S Corporation, partnership, proprietorship, etc.): ____________
____
15. List the major stockholders (partners or owners) of the company and their percentage of ownership. If applicable, obtain and attach a copy of the company's organization chart.

Name and (if applicable) Title	% Ownership
______________________________	______________
______________________________	______________
______________________________	______________
______________________________	______________

16. List the principal members of management.

Name and Title	Stated Qualifications (education, training, and experience)
______________________________	______________
______________________________	______________
______________________________	______________
______________________________	______________

17. Briefly describe any existing or contemplated employee bonus arrangement (individual, title, method of computation), stock option, or pension (profit sharing) plans that may affect the engagement.
____
____
____
18. List each location maintained by the company (including foreign locations, if any), the nature of the activity performed at each, and the approximate number of employees at each, i.e., plant, sales office, executive offices, etc.

Location	Activity	No. of Employees
______________	______________	______________
______________	______________	______________

19. Inquire about possible transactions with related parties that may affect the engagement.

Name of Related Party	Relationship	Type of Transaction
____________________	____________________	____________________
____________________	____________________	____________________
____________________	____________________	____________________
____________________	____________________	____________________
____________________	____________________	____________________
____________________	____________________	____________________

Operations

20. Describe the nature of the company's major assets and liabilities. ____________________
____
____
____

21. What are the company's sources of revenue and marketing methods? Describe major products, customers, etc.). ____________________
____
____

22. If the company is economically dependent on a major customer, name the customer and approximate percentage of total revenue generated by this customer. ____________________
____
____

23. Describe the components of cost of goods sold and the company's production process. __________
____
____

24. What are the major expenses of the company other than cost of goods sold? ____________________
____
____

25. Describe the company's compensation methods, i.e., salary , hourly wage, commissions, piece work, union scale, etc. ____________________
____
____

26. What are the company's major sources of financing, i.e., working capital loans, long term debt, leasing, equity, etc. Describe restrictive covenants on any loan agreements. ____________________
____
____

27. Is management sufficiently knowledgeable about its activities and financial condition? __________
____
____

28. Does it appear that the entity's activities or resources are heavily concentrated in one or a few high-risk areas? ____________________
____
____

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Accounting

29. Does the company maintain the following items? [Attach description, if appropriate.]
    a. Accounting manual? ______
    b. Budget? ______
    c. Cost accounting system? ______
    d. Information technology? (indicate type of equipment and software) ______
    ______
    e. Written credit policy? ______

30. Briefly describe the accounting system and accounting responsibilities.

Description of Accounting Record	Name of Person Who is Responsible	Information Technology	Manual	N/A
General Ledger	______	______	______	______
Subsidiary Ledgers:				
Accounts receivable	______	______	______	______
Fixed assets	______	______	______	______
Loans payable	______	______	______	______
Accounts payable	______	______	______	______
Perpetual inventory	______	______	______	______
Physical inventory summarization	______	______	______	______
______	______	______	______	______
______	______	______	______	______
______	______	______	______	______
Journals:				
Cash receipts	______	______	______	______
Cash disbursements	______	______	______	______
Sales/purchase/voucher	______	______	______	______
Payroll	______	______	______	______
General journal entries	______	______	______	______
______	______	______	______	______
______	______	______	______	______
______	______	______	______	______
Financial Reporting [Indicate basis of accounting]:				
Annual financial statements	______	______	______	______
Monthly financial statements	______	______	______	______
Management reports	______	______	______	______
______	______	______	______	______
Other:				
Bank reconciliations	______	______	______	______
______	______	______	______	______

31. Describe the company's completeness procedures and methods to insure that accounting transactions enter into the accounting system, i.e., that all shipments or services are invoiced, that all cash sales are recorded, and that all disbursements are recorded. ______
    ______
    ______

32. Describe any unusual features of the accounting system. ______
    ______
    ______

33. Are sufficient records available to perform the engagement?

34. Is management sufficiently knowledgeable about applicable accounting principles?

35. Does management understand accounting matters adequately to assume responsibility for proper valuation, presentation, and disclosure?

Tax Matters

36. Who prepares the tax returns?

37. Describe major differences between book and tax income, unusual tax elections, carry forwards or IRS examinations in process. If possible, review copies of the most recent 3 years of tax returns and attach them to this form.

Other Matters

38. Describe any significant problems that could affect the engagement, such as litigation or other contingencies, unusual agreements, and plans to acquire or dispose of significant assets, merge with another entity, enter a new area of business, convert to or expand use of information technology, etc.

39. Give the name of a current or former independent CPA.

    a. Describe any disputes over accounting matters.

40. Describe any apparent problems or areas for improvement that were noted where our firm could provide additional service or recommendations.

41. Is the client relatively free from controversy and media coverage?

Independence

42. Would service to this client cause problems of independence or conflicts of interest because of relationships with other clients or members of the staff?

Fees

43. Based on inquiries with a current or former independent CPA, if applicable, indicate the amount of any unpaid fees and the reason for nonpayment.

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44. If possible indicate the amount of fees charged by an existing or former independent CPA for the service being proposed. (The CPA or the potential client may be willing to furnish this information, or it might be obtainable from the financial statements or tax return.)________________________________

45. Describe any other indications that our firm might have a problem billing or collecting our fees. _____
____
____

46. Does the prospective fee justify pursuing this engagement?______________________________________
____
____

Management Integrity

47. Have any of the following sources raised any concerns about management's integrity?
    a. Difficulty in obtaining information from management, or evasive, guarded or glib responses to inquiries. ____
    ____
    b. Apparent difficulty in meeting financial operations or a deteriorating financial position that might predispose management to commit fraud or make a misrepresentation. ________________________
    ____
    c. Disputes about accounting principles, engagement procedures or similarly significant matters with an existing or former accountant, or doubts of the predecessor accountant about management's integrity. ____
    ____
    d. Comments by bankers, attorneys, creditors, or others having a business relationship with a potential client. ____
    ____

48. If management is changing accountants, why is the change being made, and is the reason for the change acceptable? ____
____
____

49. Is there any reason to suspect that management would be uncooperative, unreasonable or otherwise unpleasant to work with? ____
____
____

50. Does the general integrity of the client seem satisfactory? _____________________________________
____
____

Other Comments or Observations

51. Give any other comments or observations that might affect our decision whether to prepare a proposal letter or its contents. Add attachments to this form, if necessary. _________________________________
____
____

Conclusion

52. Should we accept/continue this client/engagement?____
____
____

.19

Summary Control Checklist

Firm Name ______________________
Quality Control Monitoring System Summary

Year Ended ______________________

Monitoring Procedure	Reviewed		Location of Documentation
	By	Date	
Analysis of the relevance of new professional pronouncements			
Continuing professional education and other professional development activities			
Independence confirmations			
Client/engagement acceptance and continuation decisions			
Interviews of firm personnel			
Review of engagements			
Inspection (describe procedures performed)			
Other procedures (describe)			
Determine that the above procedures have adequately considered and evaluated:			
1. The firm's management philosophy.			
2. Its practice environment.			
3. The relevance and adequacy of firm policies and procedures.			
4. Compliance with firm policies and procedures.			
5. Appropriateness of the firm's guidance materials and practice aids.			
6. Effectiveness of professional development activities.			

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.20 Summary Monitoring/Inspection Report

I. *Planning the Inspection*

A. Inspection period

____

B. Composition of Inspection Team:

1. Captain______________ Position ______________
2. Team Member______________ Position ______________
3. Team Member______________ Position ______________

C. Indicate matters that may require additional emphasis in the inspection and explain why.

____
____
____
____
____

D. Development of Inspection Program:

1. Describe programs used and indicate any deviations therefrom.

____
____
____
____

2. Describe basis for selection of engagements:

____
____
____

E. Timing of Inspection:

Commencement

____

Completion of work

____

Issuance of report

____

II. *Scope of Work Performed*

A. Indicate elements of quality control not addressed and give reasons.

____
____
____
____

B. Engagements Reviewed:

	Firm Totals		Engs. Reviewed	
	Hrs.	No. of Engs.	Hrs.	No. of Engs.
Audits:				
SEC Clients				
Government[2]				
ERISA				
Other				
Reviews				
Compilations				
Attestations				
Other Accounting Services	________	________	________	________
	________	________	________	________
	________	________	________	________

Comments:

____

____

____

____

III. *Engagement Conclusions*

A. Did the inspection disclose any situation that led the reviewers to conclude that the firm or office should consider:

1. Taking action to prevent future reliance on a previously issued report, pursuant to SAS No. 1 (AICPA, *Professional Standards*, AU sec. 561)? Yes ____________ No ____________

2. Performing additional auditing procedures to provide a satisfactory basis for a previously expressed opinion, pursuant to SAS No. 46 (AICPA, *Professional Standards*, AU sec. 390)? Yes ____________ No ____________

B. Did the inspection team conclude in any instances that the firm or office lacked a reasonable basis under the standards for accounting and review services for the report issued? Yes ____________ No ____________

If any of the answers above are *yes*, attach a description of such situations, including actions the firm or office has taken or plans to take.

[2] Includes only audits conducted pursuant to the *Government Auditing Standards*, issued by the Comptroller General of the United States (Yellow Book).

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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______________________

.21

> *Note:* A firm should make the analysis and assessment of the relevance of new professional pronouncements that can affect its practice, and consequently its quality control system, an ongoing activity. The AICPA's *Journal of Accountancy* publishes many of the new pronouncements in its Official Releases column. Thus, a practitioner can review the new pronouncements monthly (or after tax season for the first three months of the year) and record that review on a checklist similar to the one below.

New Pronouncements Checklist

Firm Name__________________
Analysis of New Professional Pronouncements
The purpose of this checklist is to document the firm's analysis and assessment of the relevance of new professional pronouncements to the firm practice.

		Reviewed		**Relevant?**		
Professional Pronouncement	**Effective Date**	**By**	**Date**	**Yes**	**No**	**Comment, Reference**
Auditing Standards Statement on Auditing Standards No. 121, *Revised Applicability of Statement on Auditing Standards No. 100,* Interim Financial Information (AICPA, *Professional Standards*, AU sec. 722 par. .05)	Reviews of interim financial information for periods beginning after 12/15/11					
Attestation Standards						
Auditing Interpretations						
Attestation Interpretations						
Standards for Accounting and Review Services						
Other AICPA Official Releases Technical Question and Answer section 9110.17, "Application of Financial Accounting Standards Board *Accounting Standards Codification* 740-10 (previously, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*), to Other Comprehensive of Accounting Financial Statements—Recognition and Measurement" (AICPA, *Technical Practice Aids*)	July 2010					

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New Pronouncements Checklist

Professional Pronouncement	**Effective Date**	**Reviewed**		**Relevant?**		**Comment, Reference**
		By	**Date**	**Yes**	**No**	
Other Professional Pronouncements Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (revisions published in the *Federal Register*, June 26, 2007)	Years ending on or after 12/15/06					
Financial Accounting Standards Board Accounting Standards Update No. 2011-04, *Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*	Annual periods beginning after 12/15/11					
Governmental Accounting Standards Board						
Other Pronouncements						

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References are to section and paragraph numbers.

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