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AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

AICPA Technical Practice Aids

Volume 2

**Statements of Position
Auditing and Attestation**

Practice Bulletins

Practice Alerts

As of June 1, 2002

AICPA Technical Practice Aids
As of June 1, 2002

**Volume
2**

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CHANGES AFFECTING VOLUME 2

Statements of Position—Auditing and Attestation and Practice Alerts Recently Added

<u>Statement</u>	<u>Title</u>	<u>Addition Date</u>	<u>Section</u>
SOP 01-4	<i>Reporting Pursuant to the Association for Investment Management and Research Performance Presentation Standards</i>	November 2001	11,380
SOP 02-1	<i>Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code</i>	May 2002	11,390
PA 01-2	<i>Audit Considerations in Times of Economic Uncertainty</i>	October 2001	16,200
PA 02-1	<i>Communications With the Securities and Exchange Commission</i>	Feb./March 2002	16,210
PA 02-2	<i>Use of Specialists</i>	May 2002	16,220
PA 02-3	<i>Reauditing Financial Statements</i>	September 2002	16,230

Statements of Position—Auditing and Attestation Recently Amended

<u>Statement</u>	<u>Title</u>	<u>Amended By</u>	<u>Section</u>
SOP 94-1	<i>Inquiries of State Insurance Regulators</i>	SOP 01-5	11,290
SOP 95-5	<i>Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises</i>	SOP 01-5	11,310

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HOW TO USE VOLUME 2

Scope of Volume 2 . . .

This volume, which is a reprint of a portion of volume 2 of the looseleaf edition of *Technical Practice Aids*, includes Statements of Position—Auditing and Attestation of the Audit and Attest Standards Division of the American Institute of Certified Public Accountants (AICPA), Accounting Standards Executive Committee Practice Bulletins and a list of Issues Papers of the Accounting Standards Division of the AICPA, and Practice Alerts of the AICPA SEC Practice Section Professional Issues Task Force.

How This Volume Is Arranged . . .

The contents of this volume are arranged as follows:

Statements of Position—Auditing and Attestation

Practice Bulletins

Issues Papers of the Accounting Standards Division

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How to Use This Volume . . .

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

STATEMENTS OF POSITION—AUDITING AND ATTESTATION

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

PRACTICE BULLETINS

Practice Bulletins are assigned section numbers in chronological order as they are issued. Each paragraph or equivalent is decimally numbered for reference purposes.

ISSUES PAPERS

A list of Issues Papers of the Accounting Standards Division, in chronological order, is included in a separate division.

PRACTICE ALERTS

Practice Alerts are assigned section numbers in chronological order as they are issued. Each paragraph or equivalent is decimally numbered for reference purposes.

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STATEMENTS OF POSITION AUDITING AND ATTESTATION

Introduction

Auditing and Attestation Statements of Position are issued to achieve one or more of several objectives: to revise, clarify, or supplement guidance in previously issued Audit and Accounting Guides; to describe and provide implementation guidance for specific types of audit and attestation engagements; or to provide guidance on specialized areas in audit and attestation engagements. The auditing and attestation guidance in a Statement of Position has the same authority as auditing and attestation guidance in an Audit and Accounting Guide, and members should be aware that they may be asked to justify departures from such guidance if the quality of their work is questioned.

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AUDITING AND ATTESTATION

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Section 11,040

Confirmation of Insurance Policies in Force

August 1978

NOTICE TO READERS

The American Institute of Certified Public Accountants has issued a series of industry-oriented audit guides that present recommendations on auditing procedures and auditors' reports and in some instances on accounting principles, and a series of accounting guides that present recommendations on accounting principles. Based on experience in the application of those guides, AICPA committees may from time to time conclude that it is desirable to change a guide. A statement of position is used to revise or clarify certain of the recommendations in the guide to which it relates. A statement of position represents the considered judgment of the responsible AICPA committee.

To the extent that a statement of position is concerned with auditing procedures and auditors' reports, its degree of authority is the same as that of the audit guide to which it relates. As to those matters, members should be aware that they may be called on to justify departures from the recommendations of the committee.

To the extent that a statement of position relates to standards of financial accounting or reporting (accounting principles), the recommendations of the committee are subject to ultimate disposition by the Financial Accounting Standards Board. The recommendations are made for the purpose of urging the FASB to promulgate standards that the committee believes would be in the public interest.

.01 In February 1975, the AICPA Special Committee on Equity Funding stated "... except for certain observations relating to confirmation of insurance in force and auditing related party transactions, generally accepted auditing standards are adequate and ... no changes are called for in the procedures commonly used by auditors." The AICPA industry audit guide, *Audits of Stock Life Insurance Companies* (paragraph 3.78), states: "It may also be appropriate to select in-force policies for confirmation directly with policyholders of premium amounts, date to which premiums are paid, policy loans, accumulated dividends, etc." The special committee recommended "that the Institute's auditing standards executive committee consider whether the Life Insurance Audit Guide requires clarification with regard to the confirmation of policies with policyholders."

.02 The special committee further stated:

Another auditing procedure, which heretofore has not been considered particularly useful, is verification of the authenticity of a selected number of policies included in the in-force inventory by direct confirmation with the policyholders. Such a procedure has not generally been considered necessary because it would be unusual for companies to overstate liabilities. Inflation of the inventory of life insurance in force by a company that follows statutory accounting would result in an overstatement of the liability for future policyholder benefits and a reduction in current earnings. However, when companies report on the basis of generally accepted accounting principles (GAAP) there could be motivation for overstating insurance in force because it could result in an addition to current earnings.

There could be an additional motivation for overstating insurance in force when reinsurance of policies has the effect of materially increasing current earnings, which can occur when a company reports on the basis of either GAAP or statutory accounting. Reinsurance of life insurance policies permits the elimination of the related liability for future policyholder benefits. Under certain circumstances, reinsurance may also result in increasing current earnings to the extent that the proceeds received from reinsurance exceed expenses incurred in connection with the sale and servicing of the reinsured policies.

.03 As stated above, the audit guide suggests confirmation of insurance policies in force directly with policyholders; however, the audit guide does not discuss circumstances when confirmation would be appropriate and, as a result, practice has varied. The purpose of this statement of position is to identify those circumstances in which the independent auditor ordinarily should confirm insurance policies in force. This statement of position is applicable to both stock and mutual life insurance companies.

.04 Satisfactory results of the comparison of insurance policies in force with premium collections along with other ordinary auditing procedures (see paragraphs 3.70 through 3.90, 6.08 through 6.14, and 9.02 through 9.07 of the audit guide) will normally provide the auditor with sufficient competent evidential matter as to the validity of those policies included in the inventory of insurance policies in force. However, the auditor ordinarily should confirm insurance policies in force with policyholders in the following circumstances:

- a. Proper maintenance of the inventory of insurance in force may be materially deficient due to an absence of segregation of duties or other controls.
- b. Trend analyses or ratios that measure insurance in force indicate erratic or unusual results that have not been satisfactorily explained.
- c. Additions to insurance in force cannot be related to the collection of premiums.
- d. Significant amounts of insurance in force result from related party transactions, and the related party's financial statements are not audited by the auditor.
- e. The company markets insurance products, such as those with immediate cash value features or with unusual commissions arrangements, that could motivate the agent to submit fictitious policies.
- f. Ceded reinsurance activities can materially increase earnings or investable funds.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Effective Date

.05 This statement of position provides for practices that may differ in certain respects from present acceptable practices. Accordingly, this statement of position will be effective for audits performed in accordance with generally accepted auditing standards for periods ending on or after December 31, 1978. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Confirmation of Insurance Policies in Force
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30,293

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[The next page is 30,321.]

Section 11,060**Auditing Property and Liability Reinsurance****Supplements Audits of Property and Liability Insurance Companies****October 1982****NOTICE TO READERS**

This Statement of Position presents recommendations of the Reinsurance Auditing and Accounting Task Force of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards in auditing property and liability reinsurance. This Statement of Position supplements the audit and accounting guide *Audits of Property and Liability Insurance Companies*. It represents the considered opinion of the AICPA Reinsurance Auditing and Accounting Task Force on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Introduction

.01 Reinsurance is the assumption by one insurer of all or part of a risk originally undertaken by another insurer. Reinsurance is not transacted directly with the general public, but, instead, between insurance companies. In the United States there are basically three types of reinsurance entities: professional reinsurers, reinsurance departments of primary insurance companies, and various groups or syndicates of insurers referred to as reinsurance pools or associations.

- *Professional reinsurers*, while likely permitted by their charters and licenses to operate as primary insurance companies, engage almost exclusively in reinsurance.
- *Reinsurance departments* of primary insurance companies function as units of primary insurers and engage in the reinsurance business.
- *Reinsurance pools* (also referred to as associations or syndicates) may be organized to provide their members with reinsurance protection and management for certain specialized, high-risk coverage or with general access to the reinsurance market for traditional lines of business.

In addition, reinsurance intermediaries (including brokers, agents, managing general agents, and similar entities) facilitate the business of reinsurance by bringing together reinsurance purchasers and sellers. The functions of reinsurance entities may include underwriting, designing and negotiating the terms of reinsurance, placing reinsurance, accumulating and reporting transactions, distributing premiums, and collecting and settling claims.

.02 Major reasons for insurance companies to enter reinsurance contracts are to—

- a. Reduce their exposure on particular risks or classes of risks.
- b. Protect against accumulations of losses arising from catastrophes.

- c. Reduce their total liabilities to a level appropriate to their premium volumes and amounts of capital.
- d. Provide financial capacity to accept risks and policies involving amounts larger than could otherwise be accepted.
- e. Help stabilize operating results.
- f. Obtain assistance with new products and lines of insurance.

For similar reasons, reinsurers may at times reinsure their own risks with other insurance and reinsurance companies, a practice known as retrocession.

.03 Reinsurance may be transacted under broad, automatic contracts called "treaties," which are usually of long duration and which cover some portion of a particular class of business underwritten by the insurers. Reinsurance may also be transacted under "facultative" agreements, which cover specific individual risks and require the insurer and reinsurer to agree on terms and conditions of reinsuring each risk. Reinsurance may either be "pro rata," in which the reinsurer and the insurer share proportionately in the premiums and losses, or "excess," in which only the insurer's losses above a fixed point, known as the "retention," are reinsured. (For a description of the various types of reinsurance transactions, see the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*, chapter 6.) [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.04 In ceding all or part of a risk the "ceding company" does not discharge its primary liability to its insureds. The ceding company remains fully liable for the face amount of the policy issued. Through reinsurance, the ceding company reduces its maximum exposure in the event of loss by obtaining the right to reimbursement from the "assuming company" for the reinsured portion of the loss.

.05 The accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct business. The amounts for reinsurance transactions are usually netted against the related accounts in financial statements. FASB Statement No. 60,* *Accounting and Reporting by Insurance Enterprises*, describes in paragraph 38 the accounting for ceded reinsurance:

Amounts that are recoverable from reinsurers and that relate to paid claims and claim adjustment expenses shall be classified as assets, with an allowance for estimated uncollectible amounts. Estimated amounts recoverable from reinsurers that relate to the liabilities for unpaid claims and claim adjustment expenses shall be deducted from those liabilities. Ceded unearned premiums shall be netted with related unearned premiums. Receivables and payables from the same reinsurer, including amounts withheld, also shall be netted. Reinsurance premiums ceded and reinsurance recoveries on claims may be netted against related earned premiums and incurred claim costs in the income statement.¹

* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38-40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

¹ FASB Statement No. 60,* paragraph 60f also specifies the following disclosures regarding reinsurance: "The nature and significance of reinsurance transactions to the insurance enterprise's operations, including reinsurance premiums assumed and ceded, and estimated amounts that are recoverable from reinsurers and that reduce the liabilities for unpaid claims and claim adjustment expenses."

.06 The accounting entries for reinsurance assumed normally parallel those for direct insurance. However, the extent of the detail in the information provided to the assuming company by the ceding company or the reinsurance intermediary can vary significantly regarding—

- a. Timeliness of the information submitted.
- b. Detail of information relating to policies, claims, unearned premiums, and loss reserves.
- c. Annual statement line-of-business classification.
- d. Foreign currency translation information on business assumed from companies domiciled in foreign countries (“alien companies”).

Information on losses incurred but not reported (IBNR) and bulk reserves also may be provided by ceding companies under pro rata reinsurance arrangements. Generally no IBNR will be provided on nonproportional (excess) reinsurance arrangements. Based on the quality and comprehensiveness of the detail presented, the information provided may or may not be used by the assuming company.

.07 FASB Statement No. 60* describes reporting in conformity with generally accepted accounting principles for “payments to insurance companies that may not involve transfer of risk.” Similar guidance is provided in FASB Statement No. 5,* *Accounting for Contingencies*, paragraph 44. Paragraph 40 of FASB Statement No. 60* states—

To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

Applicability and Scope

.08 This statement provides guidance on auditing property and liability reinsurance, including accident and health reinsurance. The following sections describe certain significant aspects of internal control structure policies and procedures regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states, “establishing and maintaining an internal control structure is an important management responsibility.” The concept of materiality is inherent in the work of the independent auditor, and the elements of materiality and relative risk underlie the application of generally accepted auditing standards. [Revised to reflect the

* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38–40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

conforming changes necessary due to the issuance of recent authoritative literature.]

Ceded Reinsurance

Internal Controls of the Ceding Company

.09 The ceding company should have those internal control structure policies and procedures that it considers necessary to (a) evaluate the financial responsibility and stability of the assuming company (whether the assuming company is domiciled in the United States or in a foreign country) and (b) provide reasonable assurance of the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The ceding company's control procedures to evaluate the financial responsibility and stability of the assuming company may include—

- a. Obtaining and analyzing recent financial information of the assuming company, such as—
 - Financial statements and, if audited, the independent auditor's report.
 - Financial reports filed with the Securities and Exchange Commission (U.S.), Department of Trade (U.K.), or similar authorities in other countries.
 - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development and the quality and liquidity of the company's invested assets.
- b. Obtaining and reviewing available sources of information relating to the assuming company, such as—
 - Insurance industry reporting and rating services.
 - Insurance department examination reports.
 - Loss reserve certifications filed with regulatory authorities.
 - Letters relating to the design and operation of internal control structure policies and procedures filed with regulatory authorities.
 - Insurance Regulatory Information System results filed with regulatory authorities.
- c. Inquiring about the assuming company's retrocessional practices and experience.
- d. Inquiring about the general business reputation of the assuming company and the background of its owners and management.
- e. Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or whether letters of credit or other means of security are provided if the assuming company is not so authorized.
- f. Considering the need for and evaluating the adequacy of collateral from the assuming company on certain reinsurance contracts.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.10 The ceding company's control procedures relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control procedures for the recording of insurance transactions. Those control procedures are not addressed in this statement.

Auditing Procedures

.11 In obtaining an understanding of the internal control structure, the ceding company's independent auditor should review the ceding company's procedures for determining the assuming company's ability to honor its commitments under the reinsurance contract. If the auditor intends to rely on the prescribed procedures, he should perform tests of the ceding company's procedures to obtain reasonable assurance that they are in use and operating as planned. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.12 The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the ceding company's internal control structure.² If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to evaluate the collectibility of amounts recorded in the financial statements as recoverable from the assuming company. The auditor's extended procedures may include certain of the procedures specified in paragraph .09, but they are not necessarily limited to those procedures. The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, paragraphs 40 through 48 and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.13 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the ceding company should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
 - Obtain an understanding of the business objective of the reinsurance contract, and

² SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, states, "A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions." SAS No. 60 requires the auditor to communicate to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, reportable conditions, including material weaknesses in the internal control structure that come to his or her attention during an audit. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

- Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,^{*} paragraph 40 (see paragraph .07, above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.
- c. Trace the selected transactions to supporting documents and test the related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Assumed Reinsurance

Internal Controls of the Assuming Company

.14 A significant element of the assuming company's internal control structure related to assumed reinsurance is appropriate control procedures that the company considers necessary for assessing the accuracy and reliability of data received from the ceding company (whether the ceding company is domiciled in the United States or in a foreign country). Principal control procedures of the assuming company may include—

- a. Maintaining an underwriting file with information relating to the business reasons for entering the reinsurance contract and anticipated results of the contract. The underwriting file may include—
 - Historical loss ratios and combined ratios of the ceding company.
 - Anticipated loss ratios under the contract.
 - An indication of the frequency and content of reports from the ceding company.
 - Prior business experience with the ceding company.
 - The assuming company's experience on similar risks.
 - Information regarding pricing and ceding commissions.
- b. Monitoring the actual results reported by the ceding company and investigating the reasons for and the effects of significant deviations from anticipated results.
- c. Visiting the ceding company and reviewing and evaluating its underwriting, claims processing, loss reserving, and loss reserve development monitoring procedures.
- d. Obtaining from the ceding company a special-purpose report by their independent accountant regarding the ceding company's internal

^{*} FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38—40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

accounting controls relating to ceded reinsurance (see SAS No. 30,* *Reporting on Internal Accounting Control*, paragraphs 60–61).

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

- .15 Additional control procedures of the assuming company may include—
- a. Obtaining and analyzing recent financial information of the ceding company, such as—
 - Financial statements and, if audited, the independent auditor's report.
 - Financial reports filed with the Securities and Exchange Commission (U.S.), Department of Trade (U.K.), or similar authorities in other countries.
 - Financial statements filed with insurance regulatory authorities, with particular consideration of loss reserve development.
 - b. Obtaining and reviewing available sources of information on the ceding company, such as—
 - Insurance industry reporting and rating services.
 - Insurance department examination reports.
 - Loss reserve certifications filed with regulatory authorities.
 - Letters relating to the design and operation of internal control structure policies and procedures filed with regulatory authorities.
 - Insurance Regulatory Information System results filed with regulatory authorities.
 - c. Inquiring about the general business reputation of the ceding company and the background of its owners and management.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Auditing Procedures

.16 In obtaining an understanding of the internal control structure, the assuming company's independent auditor should review the assuming company's procedures for assessing the accuracy and reliability of data received from the ceding company. If the auditor intends to rely on the prescribed procedures, he should perform tests of the company's procedures to obtain reasonable assurance that they are in use and operating as planned. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.17 The absence of adequate procedures by the assuming company to obtain assurance regarding the accuracy and reliability of data received from

* On April 20, 1992, the AICPA's Auditing Standards Board issued an exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*. The Statement would supersede SAS No. 30. A final statement is expected to be issued in 1993. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

the ceding company, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the assuming company's internal control structure.³ If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to obtain assurance regarding the accuracy and reliability of the data received from the ceding company. The auditor's extended procedures should ordinarily include, but would not necessarily be limited to, one or more of the following:

- a. Performing certain of the principal control procedures specified in paragraph .14
- b. Visiting the ceding company's independent auditor and reviewing his working papers (see SAS No. 1, section 543.12.)
- c. Performing auditing procedures at the ceding company or requesting the independent auditor of the ceding company to perform agreed-upon procedures
- d. Obtaining the report of the ceding company's independent auditor on policies and procedures (relating to ceded reinsurance) placed in operation and tests of operating effectiveness (see SAS No. 70, *Service Organizations*.)

The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, paragraphs 40 through 48 and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.18 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
 - Obtain an understanding of the business objective of the reinsurance contract.
 - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,^{*} paragraph 40 (see paragraph .07, above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.

³ See footnote 2.

^{*} FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38–40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

- c. Trace the selected transactions to supporting documents and test the related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Pools, Associations, and Syndicates

.19 Participation in reinsurance pools, associations, and syndicates is in some respects similar to reinsurance, and the guidance in paragraphs .14–.18 is generally applicable in the audit of an assuming company (participating company). Pools, associations, and syndicates often issue audited financial statements to participating companies, and the auditor of a participating company may use the report of the independent auditor of the pool, association, or syndicate in his audit. Guidance on the auditor's considerations in those circumstances is provided in SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Reinsurance Intermediaries

.20 Reinsurance may be transacted and serviced directly between the ceding and assuming companies or through reinsurance intermediaries (including brokers, agents, managing general agents, or similar entities). When a reinsurance intermediary is involved, the control procedures of the reinsurance intermediary are an integral part of the reinsurance transaction. The assuming and ceding companies should coordinate their control procedures with those of the reinsurance intermediary.

.21 A company may delegate to a reinsurance intermediary the performance of the procedures described in paragraphs .09 and in .14 and .15. The company, however, should have procedures to satisfy itself that the reinsurance intermediary is adequately performing those procedures. The guidance provided the independent auditor in paragraphs .11 and .12 and in .16 and .17 is applicable.

.22 In addition to the functions discussed in paragraphs .09 and in .14 and .15, a reinsurance intermediary may be authorized to collect, hold, disburse, and remit funds on behalf of the insurance company. The insurance company should have controls to provide reasonable assurance that the reinsurance intermediary is—

- a. Adequately performing those functions.
- b. Safeguarding the funds and, if required, appropriately segregating the funds.
- c. Settling accounts on a timely basis.

The insurance company may accomplish this by obtaining a special report from the independent auditor of the reinsurance intermediary or by visiting the reinsurance intermediary and reviewing its controls relating to those functions. The auditor of the insurance company should review the company's internal control procedures, and, if he intends to rely on them, he should test the operation of those control procedures. If the auditor decides not to rely on those controls, he should extend his procedures to obtain assurance that the objectives described in a–c above are met.

Effective Date

.23 This statement of position provides for practices that may differ in certain respects from present practices. Accordingly, this statement of position

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Statements of Position

will be effective for audits performed in accordance with generally accepted auditing standards for periods ending on or after December 31, 1983. Earlier application is encouraged. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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Section 11,070

Auditing Life Reinsurance

Supplements *Audits of Stock Life Insurance Companies*

November 1984

NOTICE TO READERS

This statement of position presents the recommendations of the Reinsurance Auditing and Accounting Task Force of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards in auditing life reinsurance. This statement of position supplements the industry audit guide, *Audits of Stock Life Insurance Companies*. It represents the considered opinion of the Reinsurance Auditing and Accounting Task Force on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Applicability

.01 This statement provides guidance on auditing life reinsurance. Guidance on auditing property and liability reinsurance, including accident and health reinsurance, is provided in the statement of position entitled, *Auditing Property and Liability Reinsurance*, issued by the AICPA Auditing Standards Division in October 1982.

Introduction

.02 When an insurance company issues life insurance policies, it undertakes a number of risks relating to the ultimate profitability of the policies, such as adverse experience regarding mortality or terminations, inadequate investment earnings, and unanticipated costs. Reinsurance is the assumption by one insurer (the assuming company) of all or part of the risks originally undertaken by another insurer (the ceding company).

.03 Each life insurance company determines its *retention limit*, which represents the maximum loss exposure acceptable to the company that could result from the death of any individual insured by the company. The retention limit will vary depending on the age of the insured at issuance of the policy, the type of insurance plan involved, and whether the insured is classified as a standard or substandard risk. If the policy exceeds the retention limit, the company will reinsure the excess portion of the risk. A company may also reinsure part or all of a policy within its retention limit if the company sees a need to limit its risk.

.04 Reinsurance also provides a means for the company to meet certain other objectives such as to avoid "surplus strain" resulting from the statutory accounting treatment of expenses and reserves, to reduce fluctuations in claim experience or to stabilize mortality cost, to provide additional capacity to accept business that would otherwise have to be declined, to protect solvency, to obtain underwriting assistance regarding risk classification, or to assist in financial and tax planning strategies.

.05 By ceding all or part of the risk, the ceding company does not discharge its primary obligations to its insureds. Therefore, the ceding company is concerned with the ability of the assuming company to honor its commitments under the reinsurance contract. The assuming company, on the other hand, is concerned with the accuracy and reliability of the information received from the ceding company regarding the risks it has assumed and, in some circumstances, the ability of the ceding company to honor commitments to the assuming company. Factors that are pertinent to the auditor's evaluation of reinsurance contracts include the types of reinsurance agreements and the consequent nature of the risks transferred, contractual safeguards in the reinsurance agreements, and internal control structure regarding reinsurance maintained by the ceding company or by the assuming company. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.06 Reinsurance may be transacted through—

- a. *Facultative agreements*, whereby each risk or portion of a risk is reinsured individually, the assuming company having the option to accept or reject it.
- b. *Automatic agreements*, whereby an agreed portion of business written is automatically reinsured, thus eliminating the need to submit each risk to the assuming company for acceptance or rejection.

.07 Life reinsurance contracts generally take one of three forms: yearly renewable term, coinsurance, or modified coinsurance.

- a. *Yearly renewable term (YRT) reinsurance* involves the purchase of reinsurance on the policyholder's life on a year-by-year basis. Typically the amount of reinsurance provided and the reinsurance premium charged for a particular contract will change from year to year on a scheduled basis. The reinsurance premium will depend on factors such as the age and sex of the insured, the duration of the policy, and the underwriting classification (standard or substandard risks). Yearly renewable term reinsurance generally transfers only the mortality risk to the assuming company.
- b. *Coinsurance* differs from yearly renewable term reinsurance in that the assuming company participates in substantially all aspects of the original policy and in that the contract generally covers a longer period of time. The assuming company will receive its share of the policy premiums and pay its share of the face amount of claims and cash values on terminations. The assuming company will establish its share of the statutory policy reserves, and the ceding company will reduce its reserves for the portion reinsured. If the policy is participating, the assuming company will generally reimburse the ceding company for its share of the policyholder dividend. The assuming company also generally reimburses the ceding company for its commission outlay and usually pays an additional amount toward the ceding company's expenses. The assuming company ordinarily participates in the risks regarding investment, mortality, terminations, and other risks of the policy.
- c. *Modified coinsurance* differs from coinsurance only in that the reserves and the assets supporting the reserves remain with the ceding company. In addition to the transactions required by coinsurance, a "reserve adjustment" payment between the assuming and ceding

companies is made each year. The assuming company will be paid interest on the assets supporting the reserves according to a specified formula, which may involve a fixed rate or may be related to the interest earnings of the ceding company. Depending on the formula, the investment risk may be borne by the ceding company or the assuming company, or it may be shared. As with coinsurance, the assuming company ordinarily participates in the mortality, termination, and other risks.

.08 Life insurance companies may also purchase *nonproportional reinsurance* on all or part of their insurance. One form of nonproportional reinsurance is stop-loss, under which the assuming company agrees to reimburse the ceding company for aggregate losses that exceed a specified amount. Another form is catastrophe reinsurance, under which the assuming company agrees to reimburse the ceding company for losses in excess of a specified amount that result from a single accident.

.09 Reinsurance agreements often provide for participation by the ceding company in the profits generated under the reinsurance. The reinsurance agreement will specify the method of computing the profit and the formula for sharing it.

.10 Typically, reinsurance agreements are individually negotiated and tailored to the needs and objectives of the ceding and assuming companies. The foregoing descriptions of life reinsurance agreements are not exhaustive, and variations from the described approaches are common.

Generally Accepted Accounting Principles

.11 The accounting entries for reinsurance ceded transactions are the opposite of the entries that arise from direct business. With certain exceptions, the amounts for reinsurance transactions are netted against the related accounts in financial statements. The accounting entries for reinsurance assumed normally parallel those for direct insurance.¹

.12 FASB Statement No. 60* describes reporting in conformity with generally accepted accounting principles for "payments to insurance companies that may not involve transfer of risk." Similar guidance is provided in FASB Statement No. 5, *Accounting for Contingencies*, paragraph 44. Paragraph 40 of FASB Statement No. 60* states—

To the extent that a reinsurance contract does not, despite its form, provide for indemnification of the ceding enterprise by the reinsurer against loss or liability, the premium paid less the premium to be retained by the reinsurer shall be accounted for as a deposit by the ceding enterprise. Those contracts may be structured in various ways, but if, regardless of form, their substance is that all or part of the premium paid by the ceding enterprise is a deposit, the amount paid shall be accounted for as such. A net credit resulting from the contract shall be reported as a liability by the ceding enterprise. A net charge resulting from the contract shall be reported as an asset by the reinsurer.

¹ FASB Statement No. 60, **Accounting and Reporting by Insurance Enterprises*, specifies certain accounting and disclosure requirements for reinsurance.

* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Scope

.13 The following sections describe certain significant aspects of internal control structure regarding ceded reinsurance and assumed reinsurance and describe the related auditing procedures. SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit*, states “establishing and maintaining an internal controlling structure is an important management responsibility.” The concept of reasonable assurance is inherent in management’s determination of the nature and extent of internal control structure, and the elements of audit risk and materiality underlie the application of generally accepted auditing standards by the independent auditor. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Ceded Reinsurance

Internal Control Structure of the Ceding Company

.14 The ceding company should have those internal control structure policies and procedures that it considers necessary to (a) evaluate the financial responsibility and stability of the assuming company (whether the assuming company is domiciled in the United States or in a foreign country) and (b) provide reasonable assurance of the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company. The ceding company’s control procedures to evaluate the financial responsibility and stability of the assuming company may vary, depending on the type of contracts (such as yearly renewable term and coinsurance) and other factors, and may include²

- a. Obtaining and analyzing recent financial information of the assuming company, such as—
 - Financial statements and, if the statements are audited, the independent auditor’s report.
 - Financial reports filed with the Securities and Exchange Commission (United States), Department of Trade (United Kingdom), or similar authorities in other countries.
 - Financial statements, including the actuary’s opinion, filed with insurance regulatory authorities, with particular consideration of the quality and liquidity of the company’s invested assets.
- b. Obtaining and reviewing available sources of information relating to the assuming company, such as—
 - Insurance industry reporting and rating services.
 - Insurance department examination reports.
 - Letters relating to the design and operation of internal control structure policies and procedures filed with regulatory authorities.
 - Insurance Regulatory Information System results filed with regulatory authorities.

² The absence of one or more specific control procedures does not necessarily indicate a weakness in the internal control structure. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

- c. Inquiring about the assuming company's retrocessional practices and experience.
- d. Inquiring about the general business reputation of the assuming company and the background of its owners and management.
- e. Ascertaining whether the assuming company is authorized to transact reinsurance within the ceding company's state of domicile or whether letters of credit or other means of security are provided if the assuming company is not so authorized.
- f. Considering the need for and evaluating the adequacy of collateral from the assuming company on certain reinsurance contracts.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.15 The ceding company's control procedures relating to the accuracy and reliability of information reported to the assuming company and amounts due to or from the assuming company are generally similar in nature to other control procedures for the recording of insurance transactions. Those control procedures are not addressed in this statement.

Auditing Procedures

.16 The independent auditor's consideration of the ceding company's internal control structure ordinarily should include a review of the ceding company's procedures for determining the assuming company's ability to honor its commitments under the reinsurance contract. If the auditor intends to rely on the prescribed procedures, he should perform tests of the ceding company's procedures to obtain reasonable assurance that they are in use and operating as planned. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.17 The absence of adequate procedures by the ceding company to determine the assuming company's ability to honor its contractual commitments, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the ceding company's internal control structure.³ If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to evaluate the collectibility of amounts recorded in the financial statements as receivables or reductions of liabilities that are recoverable from the assuming company. The auditor's extended procedures may include certain of the procedures specified in paragraph .14, but they are not necessarily limited to those procedures. The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the account-

³ SAS No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*, states, "A material weakness in the internal control structure is a reportable condition in which the design or operation of one or more of the internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions." SAS No. 60 requires the auditor to communicate to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, reportable conditions, including material weaknesses in the internal control structure that come to his or her attention during an audit. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

ing records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, *Reports on Audited Financial Statements*, paragraphs 38 through 66, and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.18 Reinsurance of life insurance permits the elimination of the reinsured portion of the related liability for future policy benefits from the ceding company's financial statements. Under certain circumstances, reinsurance may also result in increasing current earnings or investable funds to the extent that the proceeds received from the assuming company exceed expenses incurred in connection with the sale and servicing of the reinsured policies. The auditor of the ceding company ordinarily should confirm insurance policies in force with policyholders when ceded reinsurance activities can materially increase current earnings or investable funds. (See the statement of position entitled *Confirmation of Insurance Policies in Force*, issued by the AICPA Auditing Standards Division, August 1978.)

.19 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the ceding company ordinarily should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
 - Obtain an understanding of the business objective of the reinsurance contract.
 - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,^{*} paragraph 40 (see paragraph .12 above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.
- c. Trace the selected transactions to supporting documents and test related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Assumed Reinsurance

Internal Control Structure of the Assuming Company

.20 A significant element of the assuming company's internal control structure related to assumed reinsurance is appropriate control procedures that the company considers necessary for assessing the accuracy and reliability of data received from the ceding company (whether the ceding company is domiciled in the United States or in a foreign country). The appropriate control

^{**} FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

procedures may vary depending on the type of contracts (such as yearly renewable term and coinsurance) and other factors. Principal control procedures of the assuming company may include⁴—

- a. Maintaining information relating to the business reasons for entering the reinsurance contract and anticipated results of the contract, such as—
 - Actuarial studies of the business assumed.
 - Anticipated profitability.
 - Anticipated termination rates.
 - Prior business experience with the ceding company.
 - The assuming company's experience on similar business.
 - Information regarding pricing and ceding commissions.
 - An indication of the frequency and content of reports from the ceding company.
- b. Monitoring the actual results reported by the ceding company and investigating the reasons for and the effects of significant deviations from anticipated results.
- c. Visiting the ceding company and reviewing and evaluating its sales, underwriting, benefits processing, and actuarial policies and procedures.
- d. Obtaining from the ceding company a special-purpose report by their independent accountant regarding the ceding company's internal accounting controls relating to ceded reinsurance (see SAS No. 30,^{*} *Reporting on Internal Accounting Control*, paragraphs 60 and 61). If the ceding company's independent auditor confirmed life insurance policies in force (see paragraph .18), the assuming company might also consider obtaining a special report from the ceding company's independent auditor regarding the results of those confirmation procedures.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.21 Additional control procedures of the assuming company may include—

- a. Obtaining and analyzing recent financial information of the ceding company, such as—
 - Financial statements and, if audited, the independent auditor's report.
 - Financial reports filed with the Securities and Exchange Commission (United States), Department of Trade (United Kingdom), or similar authorities in other countries.

⁴ See footnote 2.

^{*} On April 20, 1992, the AICPA's Auditing Standards Board issued an exposure draft of a proposed Statement on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Structure Over Financial Reporting*. The Statement would supersede SAS No. 30. A final Statement is expected to be issued in 1993. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

- Financial statements, including the actuary's opinion, filed with regulatory authorities.
- b. Obtaining and reviewing available sources of information on the ceding company, such as—
 - Insurance industry reporting and rating services.
 - Insurance department examination reports.
 - Letters relating to the adequacy of internal control structure filed with regulatory authorities.
 - Insurance Regulatory Information System results filed with regulatory authorities.
- c. Inquiring about the general business reputation of the ceding company and the background of its owners and management.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Auditing Procedures

.22 The independent auditor's consideration of the assuming company's internal control structure ordinarily should include a review of the assuming company's procedures for assessing the accuracy and reliability of data received from the ceding company. If the auditor intends to rely on the prescribed procedures, he should perform tests of the company's procedures to obtain reasonable assurance that they are in use and operating as planned. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.23 The absence of adequate procedures by the assuming company to obtain assurance regarding the accuracy and reliability of data received from the ceding company, or the lack of reasonable assurance that such procedures are in use and operating as planned, may constitute a material weakness in the assuming company's internal control structure.⁵ If the auditor assesses control risk at the maximum level, whether because of a material weakness or other reasons, he should extend his procedures to obtain assurance regarding the accuracy and reliability of the data received from the ceding company. The auditor's extended procedures should ordinarily include, but would not necessarily be limited to, one or more of the following:

- a. Performing procedures such as certain of the procedures specified in paragraph .20
- b. Visiting the ceding company's independent auditor and reviewing his working papers (see SAS No. 1, section 543.12, *Part of Audit Performed by Other Independent Auditors*)
- c. Performing auditing procedures at the ceding company or requesting the independent auditor of the ceding company to perform agreed-upon procedures
- d. Obtaining the report of the ceding company's independent auditor on policies and procedures (related to ceded reinsurance) placed in operation and tests of operating effectiveness (see SAS No. 70, *Service Organizations*)

⁵ See footnote 3.

The auditor's inability to perform the procedures he considers necessary, whether as a result of restrictions imposed by the client or by circumstances such as the timing of the work, the inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records, constitutes a scope limitation that may require the auditor to qualify his opinion or disclaim an opinion (see SAS No. 58, paragraphs 40 through 48 and 70 through 72). In such circumstances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in his report. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

.24 To obtain reasonable assurance that reinsurance contracts are appropriately accounted for, the independent auditor of the assuming company ordinarily should perform procedures for selected contracts, selected transactions, and related balances, which include the following:

- a. Read the reinsurance contract and related correspondence to—
 - Obtain an understanding of the business objective of the reinsurance contract.
 - Determine whether the contract should be accounted for according to the provisions of FASB Statement No. 60,* paragraph 40 (see paragraph .12 above).
- b. Trace entries arising from selected reinsurance contracts to the appropriate records.
- c. Trace selected transactions to supporting documents and test the related receivables and payables.
- d. Obtain written confirmation of selected balances. In certain circumstances, confirmation of contract terms may be appropriate.

Effective Date

.25 This statement of position provides for practices that may differ in certain respects from present practices. Accordingly, this statement of position will be effective for audits performed in accordance with generally accepted auditing standards for periods ending on or after December 31, 1985. Earlier application is encouraged. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

* FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, supersedes paragraphs 38 through 40 and 60(f) of FASB Statement No. 60 and amends paragraph 44 of FASB Statement No. 5. The provisions of paragraphs 39 and 40 are incorporated in paragraph 18 of FASB Statement No. 113. FASB Statement No. 113 applies to financial statements for fiscal years beginning after December 15, 1992. [Footnote added to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

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Section 11,100

Statement of Position 89-2 Reports on Audited Financial Statements of Investment Companies

January 1989

NOTE

This statement of position presents the recommendations of the AICPA Investment Companies Committee regarding the application of generally accepted auditing standards to reports on audited financial statements of investment companies. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Introduction

.01 In 1987, the Audit and Accounting Guide, *Audits of Investment Companies*, was issued. Chapter 9 of that guide illustrates reports on audited financial statements. In April 1988, the AICPA's Auditing Standards Board issued Statement on Auditing Standards (SAS) No. 58, *Reports on Audited Financial Statements*, which changes the auditor's standard report on financial statements. This statement of position amends *Audits of Investment Companies* in response to the changes required by SAS No. 58; it replaces paragraphs 9.03 through 9.09 of the guide with new paragraphs 9.03 through 9.09*

9.03. The following form of auditor's report may be used to express an unqualified opinion on the financial statements:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Investment Companies

We have audited the accompanying statement of assets and liabilities of XYZ Investment Company, including the schedule of portfolio investments, as of December 31, 19X4, and the related statements of operations and cash flows¹ for the year then ended, the statement of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

* Paragraph 9.08 of the Guide was deleted and subsequent paragraphs were renumbered in October 1996 to reflect the new guidance set forth in SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements*. [Footnote added, June 1997.]

¹ FASB Statement No. 102, *Statement of Cash Flows—Exemption of Certain Enterprises and Classification of Cash Flows From Certain Securities Held for Resale*, amends FASB Statement No. 95, *Statement of Cash Flows*, to exempt highly liquid companies that meet specified conditions from the requirement to provide a statement of cash flows. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included confirmation of securities owned as of December 31, 19X4, by correspondence with the custodian and brokers. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows² for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

9.04 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. Also, if securities were “verified by examination,” the report should be modified to state that.

9.05 The accountant’s report for a fund referred to as a “series fund” needs to be modified because of the uniqueness of the financial statements that have evolved to present its financial position, results of operations, and cash flows. The financial position, results of operations, and cash flows of the portfolios or other entities constituting the series are frequently presented in separate columns. The financial statements of the series may also be presented as if the series were a separate entity. In both cases, the scope of the audit should be sufficient to enable the auditor to report on the individual financial statements of the various entities constituting the series fund.

9.06 The following illustration is for a multicolumnar presentation of the portfolios constituting the series:

Independent Auditor’s Report

To the Shareholders and
Board of Directors
XYZ Series Investment Company:

We have audited the accompanying statement of assets and liabilities, including the schedules of investments, of XYZ Series Investment Company (comprising, respectively, the Foreign, Domestic Common Stock, Long-Term Bond, and Convertible Preferred Portfolios) as of December 31, 19X4, and the related statements of operations and cash flows³ for the year then ended, the statements of changes in net assets for each of the two years in the period then ended,

² See footnote 1.

³ See footnote 1.

and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

[Same second paragraph as in the report illustrated in paragraph 9.03.]

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of each of the respective portfolios constituting the XYZ Series Investment Company as of December 31, 19X4, the results of their operations and their cash flows⁴ for the year then ended, the changes in their net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

9.07 The following illustration is for a presentation of one of the portfolios or entities constituting the series:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Series Investment Company:

We have audited the accompanying statement of assets and liabilities, including the schedule of portfolio investments, of the Convertible Preferred Portfolio (one of the portfolios constituting the XYZ Series Investment Company) as of December 31, 19X4, and the related statements of operations and cash flows⁵ for the year then ended, the statements of changes in net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

[Same second paragraph as in the report illustrated in paragraph 9.03.]

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of the Convertible Preferred Portfolio of the XYZ Series Investment Company as of December 31, 19X4, and the results of its operations and cash flows⁶ for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

⁴ See footnote 1.

⁵ See footnote 1.

⁶ See footnote 1.

The auditor's reports illustrated in this paragraph and in paragraph 9.06 are not intended to be all-encompassing or necessarily illustrative of all situations that may be encountered in practice.

9.08* The auditor's report should include an explanatory paragraph when the financial statements contain securities whose values were estimated by the Board of Directors in the absence of readily ascertainable market values, and the range of possible values of those securities is significant. That report, as illustrated below, should be used only if the auditor concludes that, after examining the underlying documentation supporting the board's good-faith estimate of value, the valuation principles are acceptable, are being consistently applied, are reasonably supported by the documentation, and the range of possible values is significant. If the range of possible values is not significant, a report such as that illustrated in paragraph 9.03 may be issued.

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Investment Company:

[Same first, second, and third paragraphs as in the report illustrated in paragraph 9.03.]

As explained in Note 2, the financial statements include securities valued at \$_____ (_____ % of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation, and, in the circumstances, we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, those estimated values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

Independent Auditor

Anytown, USA
January 21, 19X5

9.09 If the auditor concludes that the valuation procedures are inadequate or unreasonable, or that the underlying documentation does not support the valuation, the auditor should express a qualified opinion as follows:

Independent Auditor's Report

To the Shareholders and
Board of Directors
XYZ Investment Company:

[Same first and second paragraphs as in the report illustrated in paragraph 9.03.]

As explained in Note 2, the financial statements include securities valued at \$_____ (_____ % of net assets), whose values have been estimated by the Board of Directors in the absence of readily ascertainable market values. We have reviewed the procedures used by the Board of Directors in arriving at its estimate of value of such securities and have inspected underlying documentation. In our opinion, those procedures are not reasonable, and the documen-

* Paragraph 9.08 of the Guide was deleted and subsequent paragraphs were renumbered in October 1996 to reflect the new guidance set forth in SAS No. 79, *Amendment to Statement on Auditing Standards No. 58, Reports on Audited Financial Statements*. [Footnote added, June 1997.]

tation is not appropriate to determine the value of the securities in conformity with generally accepted accounting principles. The effect on the financial statements of not applying adequate valuation procedures is not readily determinable.

In our opinion, except for the effects on the financial statements and selected per share data and ratios of the valuation of investment securities determined by the Board of Directors, as described in the preceding paragraph, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of XYZ Investment Company as of December 31, 19X4, the results of its operations and its cash flows⁷ for the year then ended, the changes in its net assets for each of the two years in the period then ended, and the selected per share data and ratios for each of the five years in the period then ended, in conformity with generally accepted accounting principles.

Independent Auditor

Anytown, USA
January 21, 19X5

Effective Date

.02 This statement is effective at the time of its issuance.

⁷ See footnote 1.

**Investment Companies Committee
(1988-1989)**

JERRY A. DAVIS, *Chairman*
STEVEN E. BULLER
M. CHRISTOPHER CANAVAN, JR.
NICHOLAS P. CONSTANTAKIS
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Auditing
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Audit and Accounting Guides
DIONNE D. MCNAMEE, *Technical*
Manager Accounting Standards

[The next page is 30,421.]

Section 11,110

Statement of Position 89-3 Questions Concerning Accountants' Services on Prospective Financial Statements

April 1989

NOTE

This statement of position presents the recommendations of the Forecasts and Projections Audit Issues Task Force regarding accountants' services on prospective financial statements. It represents the considered opinion of the task force on the best practice for such engagements and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Reporting on Financial Forecasts That Include a Projected Sale of an Entity's Real Estate Investment

Question:

.01 The AICPA *Guide for Prospective Financial Information* ("the Guide") states that "short-term financial forecasts may not be meaningful in (a) industries with a lengthy operating cycle or (b) situations where long-term results are necessary to evaluate the investment consequences involved. It may not be practical in all situations to present financial forecasts for enough future periods to demonstrate the long-term results. In those circumstances, the presentation should include a description of the potential effects of such results. For example, if a real estate entity's forecast does not extend to the period in which the entity's investment is expected to be liquidated, the disclosures would include a discussion of the effects of a liquidation at the end of the forecast period. Exhibit 9.08 of the Guide illustrates such a disclosure."¹ The information in exhibit 9.08 is presented in a note to a financial forecast. How should the practitioner report on a financial forecast that includes a hypothetical sale of an entity's real estate investment at the end of the forecast period?

Answer:

.02 The hypothetical sale of an entity's real estate, presented to demonstrate the potential effects of long-term results, may appear in the notes to the financial forecast or in a separate statement presented as part of the financial forecast. Such presentations should be appropriately labeled and accompanied by applicable disclosures, including significant assumptions and an indication of the purpose of the presentation.

¹ See paragraph 8.34 of the Guide.

.03 When the effects of a hypothetical sale of an entity's real estate are included in a note to the financial forecast, the disclosure is part of the financial forecast and it is covered by the accountant's standard report. If the hypothetical sale is presented as a projection in a separate statement, the accountant's report should be modified to report specifically on the statement. Examples of appropriate forms of reports follow:

Examination

We have examined the accompanying forecasted balance sheet of XYZ Company as of December 31, 19X8, and the related forecasted statements of income, retained earnings, and cash flows for the year then ending (the forecast), and the accompanying statement of the effect on limited partners of the projected sale of property at December 31, 19X8 (the projection). Our examination was made in accordance with standards for an examination of prospective financial statements established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the statements.

The accompanying projection was prepared by management to provide potential investors with information to analyze the effect of a hypothetical sale of the properties as of December 31, 19X8, and should not be considered a presentation of expected future results.

In our opinion, the accompanying forecast is presented in conformity with guidelines for presentation of a forecast established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecast. Also, in our opinion, the accompanying projection is presented in conformity with guidelines for presentation of a projection established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection, assuming the hypothetical sale of properties on the date and for the sales prices indicated. However, because events and circumstances frequently do not occur as expected, there will usually be differences between the forecasted and actual results, and even if the properties are sold on the date and for the prices indicated, there will usually be differences between the projected and actual results, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Compilation

We have compiled the accompanying forecasted balance sheet of XYZ Company as of December 31, 19X8, and the related forecasted statements of income, retained earnings, and cash flows for the year then ending (the forecast), and the accompanying statement of the effect on limited partners of the projected sale of property at December 31, 19X8 (the projection). Our compilation was made in accordance with standards established by the American Institute of Certified Public Accountants.

The accompanying projection was prepared by management to provide potential investors with information to analyze the effect of a hypothetical sale of the properties as of December 31, 19X8, and should not be considered a presentation of expected future results.

A compilation is limited to presenting, in the form of a forecast or projection, information that is the representation of management, and does not include evaluation of the support for the assumptions underlying the forecast or projection. We have not examined the forecast or projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying

statements or assumptions. Furthermore, because events and circumstances frequently do not occur as expected, there will usually be differences between the forecasted and actual results, and even if the properties are sold on the date and for the prices indicated, there will usually be differences between the projected and actual results, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.04 In rare cases, management may forecast the sale of its investment in real estate during the forecast period. In such circumstances, the sale would not be hypothetical and should be included in the financial forecast with other operating results and significant changes in financial position. Furthermore, the sale would be covered by the accountant's standard report.²

Sales Prices Assumed When a Financial Forecast Includes a Projected Sale of an Entity's Real Estate Investment

Question:

.05 Paragraph 8.34 of the Guide indicates that short-term forecasts may not be meaningful in certain situations and that it may not be practical in those situations to present financial forecasts for enough future periods to demonstrate the long-term results of investment decisions. In those circumstances, the presentation should include a description of the potential effect of such results. For example, the Guide indicates that if a real estate entity's forecast does not extend to the period in which the entity's investment is expected to be liquidated, the forecast would include a discussion of the effects of a liquidation at the end of the forecast period, as shown in exhibit 9.08 of the Guide.³

.06 When disclosing the effects of a hypothetical liquidation (sale) of the entity's real estate investment at the end of the forecast period, what are appropriate assumptions for the sales price?

Answer:

.07 The Guide states (paragraph 7.01P) that although the responsible party need not have a reasonably objective basis for the hypothetical assumptions used in a projection, those assumptions should be consistent with the purpose of the projection. The purpose of disclosing the effects of a hypothetical sale of an entity's real estate investment at the end of the forecast period is to provide users with meaningful information about the long-term results of their investment decisions.

² In such rare circumstances, the accountant should treat the sale the same as any other significant assumption. For example, when examining the forecast, the accountant should consider whether the assumptions related to the sale are appropriate and suitably supported (for example, with respect to the timing of the sale and sales price). The accountant should also consider whether the assumptions should be identified by the responsible party as being particularly sensitive. Paragraph 8.25 of the Guide discusses the identification and disclosure of particularly sensitive assumptions.

³ This disclosure can be presented as a footnote to a financial forecast or as a separate schedule (see "Reporting on Financial Forecasts That Include a Projected Sale of an Entity's Real Estate Investment" [paragraphs .01-.04]).

.08 Typically, the sales price is based on a specified capitalization rate of forecasted cash flows. To be consistent with the purpose of disclosing the hypothetical sale of the entity's real estate investment, the capitalization rate assumed should be consistent with the assumptions used in the forecast as well as with the entity's and the industry's experience. If the capitalization rate assumed is not consistent with the entity's or the industry's experience, the responsible party should consider whether the resulting projected sales price is appropriate, since it may result in a presentation that is inconsistent with the objective of providing users with meaningful information about the long-term results of their investment decisions.⁴

.09 Other sales prices may also be consistent with the purpose of the projection. For example, when significant nonrecourse debt is involved, the sales price assumed is often the existing mortgage balance or the existing mortgage balance plus original capital contributions.⁵ Such assumed sales prices provide meaningful information that helps investors analyze their investment risk.

Reporting on Information Accompanying a Financial Forecast in an Accountant-Submitted Document

Question:

.10 An entity may request that additional details or explanations of items in a financial forecast (for example, details of sales or forecasted product line information) be included in an accountant-submitted document that contains a financial forecast and the accountant's report thereon. An entity may also request that certain nonaccounting information or other information not directly related to the basic forecast be included in such a document. The accompanying information is presented outside the financial forecast and is not considered necessary for the presentation of the forecast to be in conformity with guidelines for presentation of a financial forecast established by the American Institute of Certified Public Accountants. How should the accountant report on accompanying information presented outside the financial forecast in an accountant-submitted document when he or she has not been engaged to examine the information separately?

Answer:

.11 An accountant's report on information accompanying a financial forecast in an accountant-submitted document has the same objective as an accountant's report on the financial forecast: to describe clearly the character of the accountant's work and the degree of responsibility taken. When an accountant has examined a financial forecast included in an accountant-submitted document, the accountant's report on the accompanying information would ordinarily include the following:

- A statement that the examination has been made for the purpose of forming an opinion on whether (1) the financial forecast is presented

⁴ Paragraph 8.22 states that "the basis or rationale for the assumptions should preferably be disclosed to assist the user of the financial forecast (projection) to understand the forecast (projection) and make an informed judgment about it."

⁵ Paragraph 8.23P of the Guide states that "The responsible party should identify which assumptions in the projection are hypothetical."

in conformity with AICPA guidelines for the presentation of a forecast and (2) the underlying assumptions provide a reasonable basis for the forecast.

- Identification of the accompanying information.
- A statement that the accompanying information is presented for purposes of additional analysis and is not a required part of the financial forecast.
- An opinion on whether the accompanying information is fairly stated in all material respects in relation to the financial forecast taken as a whole or a disclaimer of opinion, depending on whether the information has been subjected to procedures applied in the examination of the financial forecast. The accountant may express an opinion on a portion of the accompanying information and disclaim an opinion on the remainder.⁶
- A caveat that the prospective results may not be achieved.

.12 Following are examples of reports that may be issued.⁷

Accompanying information has been subjected to procedures applied in the examination

Our examination of the financial forecast presented in the preceding section of this document was made for the purpose of forming an opinion on whether the financial forecast is presented in conformity with AICPA guidelines for the presentation of a forecast and whether the underlying assumptions provide a reasonable basis for the forecast. The [identify accompanying information] is presented for purposes of additional analysis and is not a required part of the financial forecast. Such information has been subjected to procedures applied in the examination of the financial forecast and, in our opinion, is fairly stated in all material respects in relation to the financial forecast taken as a whole. However, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Accompanying information has not been subjected to procedures applied in the examination

Our examination of the financial forecast presented in the preceding section of this document was made for the purpose of forming an opinion on whether the financial forecast is presented in conformity with AICPA guidelines for the presentation of a forecast and whether the underlying assumptions provide a reasonable basis for the forecast. The [identify accompanying information] is presented for purposes of additional analysis and is not a required part of the financial forecast. Such information has not been subjected to procedures applied in the examination of the financial forecast and, accordingly, we express no opinion or any other form of assurance on it. Furthermore, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may

⁶ If the accountant concludes, on the basis of known facts, that any accompanying information is materially misstated in relation to the financial forecast taken as a whole, he or she should discuss the matter with the responsible party and propose appropriate revision of the accompanying information or related disclosures. If the responsible party will not agree to revision of the accompanying information, the accountant should either modify the report on the accompanying information and describe his or her reservations regarding the information or refuse to include the information in the document.

⁷ The report may be added to the report on the financial forecast or may be presented with the information accompanying the financial forecast.

be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

.13 If accompanying information is included in an accountant-submitted document that includes a financial forecast and the accountant's compilation report thereon, the accountant's compilation report should also cover the other data. For example, the following paragraph may be added to the accountant's standard compilation report on a financial forecast if the accountant compiled the accompanying information.

We also compare [identify accompanying information] and, accordingly, do not express an opinion or any other form of assurance on such information.

Financial Projections Included in General-Use Documents

Question:

.14 The Guide indicates that, if a client expects to include a financial projection (as defined in paragraph 3.05 of the Guide) in a general-use document, an accountant should not submit the projection to the client or provide the client with any type of report thereon unless the projection is used to supplement a financial forecast for a period covered by the forecast.⁸ What is an accountant's responsibility for a projection (not used to supplement a financial forecast for the period covered by the forecast) included in a client-prepared general-use document when historical financial statements and the accountant's report thereon are included in the same document?

Answer:

.15 If an accountant consents to the use of his or her report on historical financial statements in a client-prepared general-use document that contains a financial projection for a period not covered by the forecast, such projection should be accompanied by an indication by the responsible party or the accountant that the accountant provides no assurance on the financial projection.^{9,10} If the accountant has audited the historical financial statements, he or she should refer to SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*. Although the accountant should consider informing the responsible party that the presentation of a financial projection for a period not covered by the forecast in a general-use document is not in conformity with the Guide, the use of such a projection in a general-use document is not presumed to be a material misstatement of fact.

Question:

.16 What is the accountant's responsibility for a financial projection (not used to supplement a financial forecast for the period covered by the forecast) included in a client-prepared general-use document when a financial forecast and the accountant's report thereon are included in the same document?

⁸ Paragraph 10.12P of the Guide states that "an accountant . . . should not submit or report on or consent to the use of his name in conjunction with a financial projection that he believes will be distributed to those who are unable to negotiate directly with the responsible party . . ." Also, see paragraph 4.05 of the Guide.

⁹ See paragraph 10.20 of the Guide.

¹⁰ In documents filed with the Securities and Exchange Commission (SEC), the responsible party should make this statement. In addition, the presentation of the financial projection should be labeled "supplemental and unaudited."

Answer:

.17 If an accountant consents to the use of his or her report on a financial forecast in a client-prepared general-use document that contains a financial projection for a period not covered by the forecast, such projection should be accompanied by an indication by the responsible party or the accountant that the accountant provides no assurance on the financial projection.¹¹ In addition, the accountant should refer to the guidance in paragraphs 10.24–10.30 of the Guide and consider informing the responsible party that the presentation of a projection for a period not covered by the forecast in a general-use document is not in conformity with the Guide.

Support for Tax Assumptions**Question:**

.18 Sometimes, one of the most sensitive assumptions underlying a financial forecast relates to the income tax treatment of prospective transactions. To obtain a reasonably objective basis for such tax assumptions, the responsible party may obtain a “tax opinion” from another practitioner, such as the entity’s tax counsel or another accountant. What responsibility does an accountant examining a financial forecast have in considering whether the tax opinion provides suitable support for tax assumptions underlying the financial forecast?

Answer:

.19 Technical training and experience, as well as knowledge of the client and its industry, enable the accountant to be knowledgeable about income tax matters and competent in assessing their presentation in prospective financial statements. Therefore, when carrying out procedures to determine whether another practitioner’s tax opinion provides suitable support for tax assumptions, the accountant is viewed as being one who is knowledgeable in income tax matters related to the entity’s forecast.¹²

.20 In determining whether another practitioner’s tax opinion provides suitable support for tax assumptions¹³ underlying a financial forecast, the accountant should¹⁴—

- a. Obtain a copy of the tax opinion expected to be issued.
- b. Apply the following procedures from SAS No. 73, *Using the Work of a Specialist*:
 - Evaluate the professional qualifications of the other practitioner including consideration of his or her (a) professional certification, license, or other recognition of professional competence, (b)

¹¹ See footnote 10.

¹² The tax opinion provided by the other practitioner may address matters of a legal nature not directly related to amounts included in the forecast—for example, matters related to the legal form of the entity. Accountants are not expected to have the technical training and experience necessary to form an opinion on legal matters.

¹³ Paragraph 15.21 of the Guide states that “the accountant should evaluate whether assumptions have been developed for all key factors upon which the entity’s financial results appear to depend.” When evaluating a tax opinion, the accountant should take into account whether all material tax issues have been considered.

¹⁴ See paragraph 15.32 of the Guide. Also, if an accountant is relying on the opinion of another practitioner in connection with a tax shelter offering, reference should be made to Internal Revenue Service regulations regarding tax shelter opinions (see appendix D to the Guide).

reputation and standing in the view of peers or others, and (c) experience in the type of work under consideration.

- Obtain an understanding of the nature of the work to be performed by the other practitioner including the (a) objectives and scope of the practitioner's work, (b) the relationship of the other practitioner to the responsible party, (c) methods or assumptions used by the other practitioner, (d) the appropriateness of using the other practitioner's work for the intended purpose, and (e) the form and content of the other practitioner's findings that will enable the practitioner to make an evaluation described in SAS No. 73, paragraph 12.
- Make appropriate tests of data provided to the other practitioner.
- Evaluate whether the other practitioner's findings support the related representations in the prospective financial statements. In doing this, the accountant should read the tax opinion and consider whether (a) the facts used in the tax opinion are consistent with the information obtained during the examination of the forecast, (b) the assumptions and arguments used in the tax opinion are reasonable,¹⁵— and (c) the assumptions, facts, and arguments used in the tax opinion support the conclusions reached.

Periods Covered by an Accountant's Report on Prospective Financial Statements

Question:

.21 The Guide includes an example of an accountant's examination report on a financial forecast "for the annual periods ending December 31, 19X2 through 19X6."¹⁶ The examination report states that the forecast was examined and concludes that (a) the forecast is presented in conformity with the presentation guidelines established by the American Institute of Certified Public Accountants, and (b) the underlying assumptions provide a reasonable basis for management's forecast. Does the accountant's examination report on a financial forecast apply to the forecast taken as a whole or to each of the discrete periods presented in the forecast?

Answer:

.22 The accountant's report on a financial forecast should correspond to the form of the forecast. Accordingly, if the forecast is presented in a columnar format in which each column represents a specific period, the accountant's report on the forecast applies to each period presented in the forecast. Conversely, an accountant's report would pertain to the entire period covered by the forecast (taken as a whole) if the presentation included a single column labeled "for the five years ending December 31, 19X6."

.23 When an accountant examines a financial forecast that presents individual discrete periods, he or she should evaluate the support for the underlying assumptions used in the preparation of the forecast for each period presented.¹⁷

¹⁵ See footnote 12.

¹⁶ See the illustrative report for a financial feasibility study in paragraph 17.27 of the Guide.

¹⁷ Paragraph 15.05 of the Guide states: "Materiality is a concept that is judged in light of the expected range of reasonableness of the information, and therefore users should not expect prospective information . . . to be as precise as historical information."

**Forecasts and Projections Audit Issues Task Force
(1988)**

KENNETH J. DIRKES, *Chairman*
RICHARD DIETER
GEORGE J. DUVA
ROBERT W. BERLINER
ERNEST L. TEN EYCK
RICHARD M. STEINBERG
DON PALLAIS
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BRUCE BALTIM
GERALD N. TUCH

DAN M. GUY
Vice President, Auditing
MIMI BLANCO-BEST
Technical Manager
Auditing Standards

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Section 11,140

Statement of Position 89-7 Report on the Internal Control Structure* in Audits of Investment Companies

December, 1989

NOTE

This statement of position presents the recommendations of the AICPA Investment Companies Committee regarding the application of generally accepted auditing standards to reports on the internal control structure in audits of investment companies. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Introduction

[.01-.02] [Paragraphs deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

Report on Internal Control Required by the SEC

.03 The following is an illustration of the independent auditor's report on a management investment company's internal control structure based on the results of procedures performed in obtaining an understanding of the internal control structure and assessing control risk. These procedures should include the review, study, and evaluation of the accounting system, internal accounting controls, and procedures for safeguarding securities required by the instructions to Form N-SAR.

Board of Directors
XYZ Investment Company

In planning and performing our audit of the financial statements of XYZ Investment Company for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding securities, in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and to comply with the requirements of Form N-SAR, not to provide assurance on the internal control structure.

The management of XYZ Investment Company is responsible for establishing and maintaining an internal control structure. In fulfilling this responsibility,

* Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. This SOP will be amended to conform to SAS No. 78 in a future edition of *Technical Practice Aids*.

estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures. Two of the objectives of an internal control structure are to provide management with reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit preparation of financial statements in conformity with generally accepted accounting principles.

Because of inherent limitations in any internal control structure, errors or irregularities may occur and not be detected. Also, projection of any evaluation of the structure to future periods is subject to the risk that it may become inadequate because of changes in conditions or that the effectiveness of the design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding securities, that we consider to be material weaknesses as defined above as of December 31, 19X1.*

This report is intended solely for the information and use of management and the Securities and Exchange Commission.

Accounting Firm

New York, New York
February 15, 19X2

Effective Date

.04 This statement is effective for audits of financial statements for periods beginning on or after January 1, 1989, with early application permissible.

* If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weaknesses do not affect the report on the financial statements. The last sentence of the fourth paragraph of the report should be modified as follows:

However, we noted the following matters involving the (control environment, accounting system, control procedures, or procedures for safeguarding securities) and its (their) operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the financial statements of XYZ Investment Company for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [A description of the material weaknesses that have come to the auditor's attention would follow. Also, Sub-item 77B of the instructions to Form N-SAR says "(d)isclosure of a material weakness should include an indication of any corrective action taken or proposed."]

**Investment Companies Committee
(1988-1989)**

JERRY A. DAVIS, *Chairman*
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Technical Manager
Accounting Standards

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Section 11,150

Statement of Position 90-1 Accountants' Services on Prospective Financial Statements for Internal Use Only and Partial Presentations

January, 1990

NOTE

This statement of position presents the recommendations of the Forecasts and Projections Task Force regarding accountants' services on prospective financial statements for internal use only and partial presentations. It represents the considered opinion of the task force on the best practice for such engagements and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Part I

Guidance on the Accountant's Services and Reports on Prospective Financial Statements for Internal Use Only*

.01 An accountant may be engaged to provide services on financial forecasts that are restricted to internal use in a variety of circumstances. For example, he or she may assemble a financial forecast in connection with an evaluation of the tax consequences of future actions or in connection with advice and assistance to a client evaluating whether to buy or lease an asset. When the forecast is to be restricted to internal use,¹ an accountant may perform a compilation, examination, or application of agreed-upon procedures in accordance with AICPA standards² or any of a spectrum of "other services" on it. The accountant need not report on such other services unless requested

* *Note:* Because financial forecasts and projections are similar in many respects, separate guidance for projections is provided only to the extent that it differs from that for forecasts. Italicized paragraphs in this section show how the guidance presented for forecasts should be modified for projections. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasts and projections even though it uses only the term *forecast*.

¹ In deciding whether a potential use is *internal use*, the accountant should consider the degree of consistency of interest between the responsible party and the user regarding the forecast. If their interests are substantially consistent (for example, both the responsible party and the user are employees of the entity about which the forecast is made), the use would be deemed internal use. On the other hand, where the interest of the responsible party and the user are potentially inconsistent (for example, the responsible party is a nonowner manager and the user is an absentee owner), the use would not be deemed internal use. In some cases, this determination will require the exercise of considerable professional judgment.

² See chapters 12, 13, and 14 of the Guide for guidance on compilations, chapters 15, 16, and 17 of the Guide for examinations, and chapters 19, 20, and 21 of the Guide for application of agreed-upon procedures.

to by the client.³ This section also suggests procedural and reporting guidance that an accountant might use in providing such other services on a financial forecast for internal use only.

.02 In satisfying himself or herself that the forecast will be restricted to internal use, the accountant may rely on either the written or oral representation of the responsible party, unless information comes to his or her attention that contradicts the responsible party's representation. If the accountant is not satisfied that the financial forecast will be restricted to internal use only, he or she should follow the guidance in paragraph 10.02 of the Guide.

Procedures

.03 The accountant's procedures should be consistent with the nature of the engagement. Other chapters of the Guide provide useful guidance on the type of procedures an accountant would apply when the nature of the engagement is similar to either a compilation, examination, or application of agreed-upon procedures.

.04 When an accountant provides other services on a financial forecast for internal use, he or she should establish an understanding with the client, preferably in writing, regarding the services to be performed and should specify in this understanding that the financial forecast and the report, if any, are not to be distributed to outside users.

Reporting

.05 The Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections*, does not require the accountant to report on other services performed on a financial forecast for internal use only. Accordingly, an accountant can submit a computer-generated or manually prepared financial forecast to a client without reporting on it when the forecast is for internal use only.

.06 If an accountant decides to issue a report and he or she purports to have compiled, examined, or applied agreed-upon procedures to a financial forecast for internal use only in conformity with AICPA standards, the accountant should follow the reporting guidance in other sections of the Guide.⁴ If the accountant decides to issue a report on other services performed with respect to a financial forecast for internal use only, the report's form and content are flexible. However, the accountant should not report on financial forecasts that exclude a summary of significant assumptions.⁵ The report preferably would—

- a. Be addressed to the responsible party.
- b. Identify the statements being reported on.
- c. Describe the character of the work performed and the degree of responsibility taken⁶ with respect to the financial forecast.
- d. Include a caveat that the prospective results may not be achieved.

³ However, see paragraph .09.

⁴ See chapters 14, 17, and 21 of the Guide for guidance on reporting on a compilation, examination, or application of agreed-upon procedures, respectively.

⁵ See paragraph 9.05 of the Guide for guidance on presentation formats for disclosure of significant assumptions.

⁶ The accountant's assurance on the financial forecast should not be similar to that given for an examination unless he or she complies with the procedures for an examination as described in chapter 15 of the Guide.

- e. Indicate the restrictions as to the distribution of the financial forecast and report.
- f. Be dated as of the date of the completion of his or her procedures.

.06P *In addition to the elements listed above, the accountant's report on a financial projection for internal use only preferably would include a description of the limitations on the usefulness of the presentation.*

.07 In addition to the above, the accountant's report would, where applicable, preferably—

- a. Indicate if the accountant is not independent with respect to an entity on whose financial forecast he or she is providing services. An accountant should not provide any assurance on a financial forecast of an entity with respect to which he or she is not independent.
- b. Describe omitted disclosures that come to his or her attention (for example, the omission of the summary of significant accounting policies discussed in paragraph 8.06 of the Guide), or simply state that there are omissions of disclosures required under the guidelines for presentation of a financial forecast. For example, when a financial forecast is included in a personal financial plan, the description may be worded as follows:

This financial forecast was prepared solely to help you develop your personal financial plan. Accordingly, it does not include all disclosures required by the guidelines established by the American Institute of Certified Public Accountants for the presentation of a financial forecast.

.08 The following is an example report, for cases in which the accountant chooses to issue a report, when he or she has assembled a financial forecast for which distribution is limited to internal use:

We have assembled, from information provided by management, the accompanying forecasted balance sheet and the related forecasted statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 19XX, and for the year then ending.

*(This financial forecast omits the summary of significant accounting policies.)*⁷ We have not compiled or examined the financial forecast and express no assurance of any kind on it. Further, there will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. In accordance with the terms of our engagement, this report and the accompanying forecast are restricted to internal use and may not be shown to any third party for any purpose.

.08P *The following is an example report, for cases in which the accountant chooses to issue a report, when an accountant has assembled a financial projection for which distribution is limited to internal use:*

*We have assembled, from information provided by management, the accompanying projected balance sheet and the related projected statements of income, retained earnings, and cash flows of XYZ Company as of December 31, 19XX, and for the year then ending. (This financial projection omits the summary of significant accounting policies.)*⁸ *The accompanying projection and this report were prepared for [state special purpose, for example, "presentation to the Board of Directors of XYZ Company for its consideration as to whether to add*

⁷ This sentence would be included, if applicable.

⁸ This sentence would be included, if applicable.

a third operating shift"] and should not be used for any other purpose. We have not compiled or examined the financial projection and express no assurance of any kind on it. Further, even if [state hypothetical assumption, for example, "the third operating shift is added"] there will usually be differences between the projected and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material. In accordance with the terms of our engagement, this report and the accompanying projection are restricted to internal use and may not be shown to any third party for any purpose.

.09 When a financial forecast for internal use only is included with an accountant's written communication (for example, with a transmittal letter or report), a caveat that the prospective results may not be achieved and a statement that the financial forecast is for internal use only should be communicated in writing. Such caveat and statement should be included in the communication on or in the prospective financial statements.

Part II

Partial Presentations of Prospective Financial Information

Introduction

.10 Much of the guidance in the AICPA's *Guide for Prospective Financial Statements* (the "Guide") can be applied to partial presentations of prospective financial information. This section—

- Describes how that guidance applies to the unique aspects of partial presentations.
- Discusses the accountant's responsibility for partial presentations when he or she is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written partial presentation that is the responsibility of another party (see paragraph .25).

.11 A partial presentation is a presentation of prospective financial information that excludes one or more of the items required for prospective financial statements as described in paragraph 8.06 of the Guide.⁹ A partial presentation may include either forecasted or projected information and may either be extracted from a presentation of prospective financial statements or may be prepared to meet a specific need.¹⁰ Examples of partial presentations include—

- Sales forecasts.
- Presentations of forecasted or projected capital expenditure programs.

* *Note:* Because forecasted and projected information is similar in many respects, separate guidance for projected information is provided only to the extent that it differs from that for forecasted information. Italicized paragraphs show how the guidance presented for forecasted information should be modified for projected information. Any plain-text paragraph not followed by an italicized paragraph applies to both forecasted and projected information even though it uses only the term *forecasted*.

⁹ Paragraph 8.06 of the Guide indicates that a financial forecast may take the form of complete basic financial statements or may be limited to the following items (where such items would be presented for historical financial statements for the period):

- a. Sales or gross revenues
- b. Gross profit or cost of sales
- c. Unusual or infrequently occurring items
- d. Provision for income taxes
- e. Discontinued operations or extraordinary items
- f. Income from continuing operations
- g. Net income
- h. Primary and fully diluted earnings per share
- i. Significant changes in financial position

When the financial forecast takes the form of basic financial statements, the requirement to disclose significant changes in financial position in *i* above is accomplished by presenting a statement of cash flows and its related note disclosures in accordance with FASB Statement No. 95, *Statement of Cash Flows*.

If the omitted applicable item is derivable from the information presented, the presentation would not be deemed to be a partial presentation. Paragraph 8.08 of the Guide states that a summary of significant assumptions and accounting policies and an appropriate introduction should always accompany the forecast.

¹⁰ Partial presentations do not include estimates in historical financial statements and related notes required by generally accepted accounting principles or an other comprehensive basis of accounting. Guidance on auditing accounting estimates is contained in SAS No 57, *Auditing Accounting Estimates*.

- Projections of financing needs.
- Other presentations of specified elements, accounts, or items of prospective financial statements (for example, projected production costs) that might be part of the development of a full presentation of prospective financial statements.
- Forecasts that present operating income but not net income.
- Forecasts or projections of taxable income that do not show significant changes in financial position.
- Presentations that provide enough information to be translated into elements, accounts, or items of a financial forecast or projection. Examples include a forecast of sales units and unit selling prices and a forecast of occupancy percentage, number of rooms, and average room rates for a hotel. In contrast, if the prospective information only presents units expected to be sold but excludes unit selling prices, it would not be considered a partial presentation.

Uses of Partial Presentations

.12 Partial presentations may be appropriate in many “limited use” circumstances.¹¹ For example, a responsible party may prepare a partial presentation to analyze whether to lease or buy a piece of equipment or to evaluate the income tax implications of a given election, since it may only be necessary to assess the impact on one aspect of financial results rather than on the financial statements taken as a whole. However partial presentations are not ordinarily appropriate for general use. Accordingly, a partial presentation ordinarily should not be distributed to third parties who will not be negotiating directly with the responsible party (for example, in an offering document for an entity’s debt or equity interests). In this context, *negotiating directly* is defined as a third-party user’s ability to ask questions of and negotiate the terms or structure of a transaction directly with the responsible party.

.13 The responsible party should consider whether a presentation omitting one or more items required for prospective financial statements will adequately present the information given its special purpose. Unless there is agreement between the responsible party and potential users specifying the content of the partial presentation, a partial presentation is inappropriate if it is incomplete for what it purports to present. Examples of partial presentations that might be inappropriate include a statement of forecasted receipts and disbursements that does not include certain existing commitments of the entity or a forecast of net income that does not include disclosure of changes in financial position, when such disclosures would indicate the need for additional capital to sustain operations. A presentation of prospective sales, however, is an example of a presentation that would be appropriate in circumstances where its intended use is to negotiate the terms of a royalty agreement based on sales.

Preparation and Presentation of Partial Presentations

.14 Partial presentations omit one or more of the minimum items required in paragraph 8.06 of the Guide for prospective financial statements.¹² The

¹¹ See paragraphs 3.13 and 4.04 of the Guide.

¹² As used here, prospective financial statements include complete basic financial statements or the minimum items described in paragraph 8.06 of the Guide (see footnote 1).

guidance below describes matters to be considered in the preparation and presentation of partial presentations.

.15 Key Factors. If the responsible party prepares a partial presentation without preparing prospective financial statements, the responsible party should consider key factors affecting elements, accounts, or items of prospective financial statements that are interrelated with those presented. In a sales forecast, for example, a key factor to be considered is whether productive capacity is sufficient to support forecasted sales. When the prospective information included in the partial presentation is extracted from the prospective financial statements, the effects of interrelationships among elements of the prospective financial statements should have been previously determined.

.16 Titles. Titles of partial presentations should be descriptive of the presentation and state whether the presentation is of forecasted or projected information. In addition, titles should disclose the limited nature of the presentation and should not state that it is a "financial forecast" or a "financial projection." Examples of appropriate titles are "forecast of production capacity" and "projected operating income assuming a new plant facility."

.17 Accounting Principles and Policies. Significant accounting policies relevant to the information presented and its intended purpose should be disclosed.

.18 Occasionally, a different basis of accounting is used for preparing a partial presentation than that expected to be used in preparing the historical financial statements covering the same period as the partial presentation. In such circumstances, the presentation should disclose the basis of accounting to be used to prepare the historical financial statements covering the prospective period. Differences resulting from the use of the different basis to prepare the partial presentation should be described but need not be quantified.

.19 Materiality. The concept of materiality should be related to the partial presentation taken as a whole.

.20 Assumptions. Assumptions that are significant to a partial presentation include those assumptions having a reasonable possibility of a variation that may significantly affect the prospective results. Such assumptions may be either directly or indirectly related to the presentation. The selling price of a product, for example, is an assumption that could directly affect a sales forecast, whereas a company's productive capacity is an example of an assumption that could indirectly affect the sales forecast. Frequently, the more indirectly related an assumption is to the partial presentation, the greater the potential variation would have to be to have a material impact on the prospective results presented.

.21 In some situations, the disclosure of assumptions deemed to be significant to the partial presentation of prospective financial information would be virtually the same as those disclosures that would be necessary if a full presentation of prospective financial statements were to be made. For example, in a partial presentation of forecasted operating results, it is likely that most assumptions that would be significant with respect to a full presentation would also be significant with respect to the presentation of forecasted operating results. Thus, those assumptions should be disclosed.

.22 In other, more limited partial presentations of prospective financial information, however, there may be few assumptions having a reasonable pos-

sibility of a variation that would significantly affect the presentation. In a presentation of forecasted sales, for example, it would only be necessary to disclose those assumptions relating directly to the sales forecast, such as future demand and pricing, unless other assumptions—such as marketing and advertising programs, productive capacity and production costs, financial stability or working capital sufficiency—have a reasonable possibility of a variation significant enough to have a material impact on the sales forecast.

.23 The introduction preceding the summary of assumptions for a partial presentation should include a description of the purpose of the presentation and any limitations on the usefulness of the presentation.

.24 The following is an example of the introduction for a partial presentation of forecasted sales:

This sales forecast presents, to the best of management's¹³ knowledge and belief, expected sales during the forecast period. Accordingly, the sales forecast reflects its judgment as of (date), the date of this forecast, of the expected conditions and its expected course of action. The sales forecast is for use in negotiating the Company's lease override provisions and should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the sales forecast. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

.24P *The following is an example of the introduction preceding the summary of assumptions for a schedule of projected production at a maximum productive capacity:*

This projection of production by product line presents, to the best of management's¹⁴ knowledge and belief, the Company's expected production for the period if management chooses to operate its plant at maximum capacity. Accordingly, the projection of production by product line reflects its judgment as of (date), the date of this projection, of the expected conditions and its expected course of action if the plant were operated at maximum capacity. The projected statement is designed to provide information to the Company's board of directors concerning the maximum production that might be achieved and related costs if current capacity were expanded through the addition of a third production shift. Accordingly, this projected statement should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the projected statement; however, management has not decided to operate the plant at maximum capacity. Even if the plant were operated at maximum capacity, there will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

Accountant's Involvement With Partial Presentations

.25 An accountant who is engaged to issue or does issue a written communication¹⁵ that expresses a conclusion about the reliability¹⁶ of a written par-

¹³ If the responsible party is other than management, this reference should be to the party who assumes responsibility for the assumptions.

¹⁴ See footnote 5.

¹⁵ An accountant should not report on a partial presentation that excludes disclosure of the summary of significant assumptions or, for a projection, excludes identification of the hypothetical assumptions.

¹⁶ Reliability, as it applies to a partial presentation, does not relate to the achievability of the prospective results.

tial presentation¹⁷ that is the responsibility of another party should examine or apply agreed-upon procedures to the presentation.¹⁸ An accountant may also be engaged to compile a partial presentation. When an accountant compiles, examines, or applies agreed-upon procedures to a partial presentation, he or she should perform the engagement in accordance with the guidance in paragraphs .29 and .30.¹⁹

.26 This section does not provide standards or procedures for engagements involving partial presentations used solely in connection with litigation services, although it provides helpful guidance for many aspects of such engagements and may be referred to as useful guidance in such engagements. *Litigation services* are engagements involving pending or potential formal legal or regulatory proceedings before a "trier of fact" in connection with the resolution of a dispute between two or more parties, for example, in circumstances where an accountant acts as an expert witness. This exception is provided because, among other things, the accountant's work in such proceedings is ordinarily subject to detailed analysis and challenge by each party to the dispute.²⁰

.27 The accountant should consider whether it is appropriate to report on a partial presentation.²¹

.28 Occasionally, an accountant may be engaged to prepare a financial analysis of a potential project where the engagement includes obtaining the information, making appropriate assumptions, and assembling the presentation. In such circumstances, the accountant is the assertor and the analysis is not, and should not be characterized as, forecasted or projected information as defined in paragraph .11. Such analysis would not be appropriate for general use.²²

Compilation and Examination Procedures

.29 The procedures for compilations and examinations of prospective financial statements are generally applicable to partial presentations.²³ However, the accountant's procedures may be affected by the nature of the information presented. As described in paragraph .15, many elements of prospective financial statements are interrelated. The accountant should give appropriate consideration to whether key factors affecting elements, accounts, or items that are interrelated with those in the partial presentation he or she has been engaged to examine or compile have been considered, including key factors that may not necessarily be obvious from the partial presentation (for

¹⁷ This statement covers only a partial presentation presented in written form by the party responsible for it. Consistent with the attestation standards, oral assertions about prospective results are not addressed by this statement.

¹⁸ Examples of professional standards that may involve partial presentations not covered by this section are included in paragraph 2 of the Statements on Standards for Attestation Engagements (AICPA, *Professional Standards*, vol. 1, AT sec. 100). In addition, paragraphs 76–81 of that section contain guidance that an accountant should follow when he or she provides an attest service as part of an MAS engagement.

¹⁹ If the accountant provides services on a partial presentation restricted to internal use only, he or she may apply the guidance in paragraphs .01–.09 of Part I of this section.

²⁰ See paragraph 10.03 of the Guide.

²¹ See paragraphs .12 and .13.

²² If the responsible party reviews and adopts the assumptions and presentation, the presentation might be a partial presentation. See paragraphs .11 and .12 for the definition and uses of partial presentations.

²³ See chapters 12 and 15 of the Guide.

example, productive capacity relative to a sales forecast), and whether all significant assumptions have been disclosed. The accountant may find it necessary for the scope of his or her examination or compilation of some partial presentations to be similar to that for his or her examination or compilation of a presentation of prospective financial statements. For example, the scope of an accountant's procedures when he or she examines forecasted results of operations would likely be similar to those for his or her examination of prospective financial statements since the accountant would likely need to consider the interrelationships of all accounts in the examination of results of operations.

Applying Agreed-Upon Procedures to Partial Presentations

.30 An accountant may accept an engagement to apply agreed-upon procedures to a partial presentation provided (a) the specified users involved have participated in establishing the nature and scope of the engagement and take responsibility for the adequacy of the procedures to be performed, (b) distribution of the report is to be restricted to the specified users involved, and (c) the partial presentation includes a summary of significant assumptions. The guidance in chapter 19 of the Guide is generally applicable to such engagements.

Standard Accountant's Compilation, Examination, and Agreed-Upon Procedures Reports

.31 The accountant's standard report on a partial presentation should include—

- An identification of the partial presentation reported on.
- A caveat that the forecasted results may not be achieved.
- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.
- A description of any limitations on the usefulness of the presentation.
- For a compilation
 - A statement that the accountant has compiled the partial presentation in accordance with guidelines established by the American Institute of Certified Public Accountants.
 - A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the partial presentation of the assumptions.
- For an examination
 - A statement that the examination of the partial presentation was made in accordance with AICPA standards and a brief description of the nature of such an examination.
 - For forecasted information, the accountant's opinion that the partial presentation is presented in conformity with AICPA presentation guidelines and that the underlying assumptions provide a reasonable basis for the forecast.
 - *For projected information, the accountant's opinion that the partial presentation is presented in conformity with AICPA presenta-*

tion guidelines and that the underlying assumptions provide a reasonable basis for the projection given the hypothetical assumptions.

- For an agreed-upon procedures engagement
 - A statement that the report is intended solely for the specified users, and should not be used by others.
 - An enumeration of the procedures performed and a reference to conformity with the arrangements made with the specified users.
 - If the agreed-upon procedures are less than those performed in an examination, a statement that the work performed was less in scope than an examination of a partial presentation in accordance with AICPA standards, and
 - For forecasted information, a disclaimer of opinion on whether the presentation is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the forecast.
 - *For projected information, a disclaimer of opinion on whether the presentation is in conformity with AICPA presentation guidelines and on whether the underlying assumptions provide a reasonable basis for the projection given the hypothetical assumptions.*
- A statement of the accountant's findings.²⁴

.32 Chapters 14, 17, and 21 of the Guide describe circumstances where the accountant's standard report on a financial forecast may require modification. The guidance for modifying the accountant's standard reports included in those sections is generally applicable to partial presentations. Also, depending on the nature of the presentation, the accountant may decide to disclose that the partial presentation is not intended to be a forecast of financial position, results of operations, or cash flows. The following are the forms of the accountant's standard report when he or she has compiled, examined, or applied agreed-upon procedures to a partial presentation.²⁵

Compilation Report on a Partial Presentation of Forecasted Information

We have compiled the accompanying forecasted statement of net operating income before debt service, depreciation, and income taxes of AAA Hotel for the year ending December 31, 19X1 (the forecasted statement) in accordance with guidelines established by the American Institute of Certified Public Accountants.

The accompanying forecasted statement presents, to the best of management's knowledge and belief, the net operating income before debt service, depreciation, and income taxes of AAA Hotel for the forecast period. It is not intended to be a forecast of financial position, results of operations, or cash flows. The

²⁴ The accountant may wish to state in his or her report that he or she makes no representation about the sufficiency of the procedures for the specified users' purposes.

²⁵ These report forms are appropriate whether the presentations are based on generally accepted accounting principles or on an other comprehensive basis of accounting.

accompanying forecasted statement and this report were prepared for the ABC Bank for the purpose of negotiating a proposed construction loan to be used to finance expansion of the hotel and should not be used for any other purpose.

A compilation is limited to presenting forecasted information that is the representation of management and does not include evaluation of the support for the assumptions underlying such information. We have not examined the forecasted statement and, accordingly, do not express an opinion or any other form of assurance on the accompanying statement or assumptions. Furthermore, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Compilation Report on a Partial Presentation of Projected Information

We have compiled the accompanying sales projection of XYZ Company for each of the years in the three-year period ending December 31, 19X1 in accordance with guidelines established by the American Institute of Certified Public Accountants.

The accompanying sales projection presents, to the best of management's knowledge and belief, the Company's expected sales during the projection period that would result if the Company achieved a 15 percent market share of the electric toaster market, as disclosed in items b and c of the summary of significant assumptions. The sales projection and this report were prepared for presentation to the Board of Directors of XYZ Company for its consideration of a new marketing program and should not be used for any other purpose.

A compilation is limited to presenting projected information that is the representation of management and does not include evaluation of the support for the assumptions underlying such information. We have not examined the sales projection and, accordingly, do not express an opinion or any other form of assurance on the accompanying sales projection or assumptions. Furthermore, even if the Company attained the 15 percent market share of the electric toaster market, there will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Examination Report on a Partial Presentation of Forecasted Information

We have examined the accompanying forecasted statement of net operating income before debt service, depreciation, and income taxes of the AAA Hotel for the year ending December 31, 19X1 (the forecasted statement). Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the forecasted statement.

The accompanying forecasted statement presents, to the best of management's knowledge and belief, the expected net operating income before debt service, depreciation, and income taxes of AAA Hotel for the forecast period. It is not

intended to be a forecast of financial position, results of operations, or cash flows. The accompanying forecasted statement and this report were prepared for ABC Bank for the purpose of negotiating a proposed construction loan to be used to finance expansion of the hotel and should not be used for any other purpose.

In our opinion, the forecasted statement referred to above is presented in conformity with the guidelines for presentation of forecasted information established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's forecasted statement. However, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Examination Report on a Partial Presentation of Projected Information

We have examined the accompanying sales projection of XYZ Company for each of the years in the three-year period ending December 31, 19X1. Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and, accordingly, included such procedures as we considered necessary to evaluate both the assumptions used by management and the preparation and presentation of the sales projection.

The accompanying sales projection presents, to the best of management's knowledge and belief, the Company's expected sales during the projection period that would result if the Company achieved a 15 percent market share of the electric toaster market, as disclosed in items b and c of the summary of significant assumptions. The sales projection and this report were prepared for presentation to the Board of Directors of XYZ Company for its consideration of a new marketing program and should not be used for any other purpose.

In our opinion, the sales projection referred to above is presented in conformity with the guidelines for presentation of projected information established by the American Institute of Certified Public Accountants, and the underlying assumptions provide a reasonable basis for management's projection of expected sales during the period assuming the Company were to achieve a 15 percent market share of the electric toaster market. However, even if the Company achieves a 15 percent market share, there will usually be differences between projected and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.

Agreed-Upon Procedures Report on a Partial Presentation of Forecasted Information

At your request, we have performed certain agreed-upon procedures, as enumerated below, with respect to the sales forecast of XYZ Company for the year ending December 31, 19X1. These procedures, which were specified by the Boards of Directors of XYZ Company and ABC Corporation, were performed solely to assist you, and this report is solely for your information and should not be used by those who did not participate in determining the procedures.

- a. We assisted the management of XYZ Company in assembling the sales forecast.

- b. We read the sales forecast for compliance in regard to format with the AICPA presentation guidelines for a partial presentation of forecasted information.
- c. We tested the sales forecast for mathematical accuracy.

Because the procedures described above do not constitute an examination of a presentation of forecasted information in accordance with standards established by the American Institute of Certified Public Accountants, we do not express an opinion on whether the sales forecast is presented in conformity with AICPA presentation guidelines or on whether the underlying assumptions provide a reasonable basis for the presentation.

In connection with the procedures referred to above, no matters came to our attention that caused us to believe that the format of the sales forecast should be modified or that the presentation is mathematically inaccurate. Had we performed additional procedures or had we made an examination of the sales forecast in accordance with standards established by the American Institute of Certified Public Accountants, matters might have come to our attention that would have been reported to you. Furthermore, there will usually be differences between forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material. We have no responsibility to update this report for events and circumstances occurring after the date of this report.²⁶

Effective Date

.33 The provisions of this statement are effective for engagements to provide services on prospective financial statements for internal use only and partial presentations beginning on or after July 1, 1990.

²⁶ See footnote 13.

Appendix

Illustrations of Partial Presentations

A1. The illustrative partial presentations of prospective financial information included in the following pages are presented in conformity with the presentation guidelines of the Guide, although other presentation formats could also be consistent with the Guide. For example, it may be appropriate to present the summary of significant assumptions and accounting policies in a less formal manner than that illustrated, such as computer-printed output (indicating data and relationships) from "electronic worksheets" and general purpose financial modeling software, as long as the responsible party believes that the disclosures and assumptions presented can be understood by users.

A2. The following is a brief summary of the illustrative partial presentations presented below:

- a. Example 1 illustrates a sales forecast prepared for the purpose of negotiating a retail company's lease override provisions.
- b. Example 2 illustrates a forecasted statement of net operating income before debt service and depreciation in connection with the contemplated construction of a new sports arena.

Example 1

ABC Retail Company
Statement of Forecasted Sales for Each of the
Three Years Ending December 31, 19X3[†]

	<i>Years Ending December 31,</i>		
	<i>19X1</i>	<i>19X2</i>	<i>19X3</i>
Forecasted sales	\$629,000	\$679,000	\$726,000

This sales forecast presents, to the best of management's knowledge and belief, expected sales during the forecast period. Accordingly, the sales forecast reflects its judgment as of February 14, 19X1, the date of this forecast, of the expected conditions and its expected course of action. The sales forecast is for use in negotiating the Company's lease override provisions and should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the sales forecast. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

This sales forecast is based upon an expected average rate of overall increase in market demand for the Company's products, sporting goods equipment, of 3 percent per year. During the past five years, market demand for sporting goods equipment has increased approximately 3 percent per year and the Company expects this rate of industry growth to remain steady throughout the forecast period. The sales forecast is also based upon an expected increase in the Company's market share in its geographical selling region to 23 percent by

[†] Note: The summary of significant accounting policies is not illustrated.

19X3, which represents a 6 to 7 percent increase in market share over the forecast period. The Company's market share during the past three years has increased one to two percentage points each year and the Company expects this rate of increase to continue during the forecast period. The sales forecast is also based upon an expected 4 to 5 percent increase in the rate of inflation for each of the next three years. The Company expects that it will be able to increase the prices of its products to cover increased costs due to inflation.

The Company plans to maintain its advertising and marketing programs at current levels and has retail-floor space available to provide for the increase in the number of products it expects to sell.

Example 2

**MARS Arena
Forecasted Statement of Net Operating Income
Before Debt Service and Depreciation for
Years Ending December 31, 19X1 and 19X2
(In thousands)**

	<i>Reference</i>	<u>19X1</u>	<u>19X2</u>
Operating revenues	C	\$2,700	\$2,600
Operating expenses			
Salaries and wages	D	1,050	1,100
Office and general	E	700	650
Utilities	F	500	510
Operations and maintenance	G	<u>150</u>	<u>160</u>
Total operating expenses		<u>2,400</u>	<u>2,420</u>
Net operating income before debt service and depreciation		<u>\$ 300</u>	<u>\$ 180</u>

See Accompanying Summary of Significant Forecast Assumptions and Accounting Policies.

**MARS Arena
Summary of Significant Forecast
Assumptions and Accounting Policies
for Years Ending December 31, 19X1 and 19X2**

The accompanying forecasted statement presents, to the best of management's knowledge and belief, MARS Arena's expected net operating income before debt service and depreciation for the two-year period ending December 31, 19X2. Accordingly, the forecasted statement reflects management's judgment as of August 29, 19X0, the date of this forecasted statement, of the expected conditions and its expected course of action. This presentation is intended for use by the City of MARS in evaluating financing alternatives in connection with the contemplated construction of the new arena and should not be used for any other purpose. The assumptions disclosed herein are those that management believes are significant to the forecasted statement. There will usually be differences between the forecasted and actual results because events and circumstances frequently do not occur as expected, and those differences may be material.

The forecasted statement presents net operating income before debt service and depreciation. Accordingly, it is not intended to be a forecast of financial position, results of operations, or cash flows.

A. Description of the Project

The City of MARS plans to build a new 10,000-seat arena at the southeast intersection of Maxwell Road and Rugby Road to replace their existing 8,000-seat arena (the City's existing arena). MARS Arena will have 3,000 available parking spaces.

B. Summary of Significant Accounting Policies

[not illustrated]

C. Operating Revenues

There are four basic types of events forecasted to generate operating income: sporting events, family shows (for example, circus, ice shows), concerts, and exhibitions. The significant sources of revenue for each type of event include arena rental, parking fees, food and beverage concessions, novelty and souvenir income, and advertising. Attendance during the initial year of operations is forecasted to be greater than the second year based on the "bonus" a new arena can enjoy as patrons come to see the new facility as well as to see the event. A summary of operating revenue by type of event follows.

<u>Year 1</u>	<u>Event Days</u>	<u>Average Attendance</u>	<u>Total Attendance</u>	<u>Total Revenue</u>
Sporting events	70	4,000	280,000	\$ 860,000
Family shows	45	4,500	202,500	515,000
Concerts	30	8,500	255,000	1,025,000
Exhibitions	25	2,500	62,500	180,000
Advertising				120,000
Totals	<u>170</u>		<u>800,000</u>	<u>\$2,700,000</u>

<u>Year 2</u>	<u>Event Days</u>	<u>Average Attendance</u>	<u>Total Attendance</u>	<u>Total Revenue</u>
Sporting events	70	3,900	273,000	\$ 835,000
Family shows	45	4,300	193,500	490,000
Concerts	30	8,200	246,000	990,000
Exhibitions	25	2,200	55,500	160,000
Advertising				125,000
Totals	<u>170</u>		<u>767,500</u>	<u>\$2,600,000</u>

The bases for the significant income assumptions are discussed below.

Arena Rental. Management estimates that the new arena will schedule approximately 170 event days in a representative year consisting of seventy sporting events, forty-five family shows, thirty concerts, and twenty-five exhibitions. Event days were forecasted based on discussions with users (such as sporting teams and event sponsors) and market research and analysis performed by an independent consultant. Also, the City of MARS recently obtained a commitment from the local minor league hockey team to play their home games in MARS Arena.

MARS Arena will be rented out on the basis of a percentage of the dollars generated by ticket sales (called a "percentage of gross receipts") or a fixed rent (called a "flat rate"). The percentage of gross gate receipts accruing to the facility are based on current average percentages retained by the City's existing arena. These percentages range from 10 to 50 percent depending on the type of event. Management expects ticket prices to increase between 5 and 15 percent over prices at the City's existing arena, depending on the type of event, as a result of the new modernized facility. Ticket prices forecasted for each type of event have been compared with those received by other facilities for similar events. Flat rate rentals are usually negotiated by users who do not charge an admission price or have a series of events. The flat rate rental for MARS Arena is forecasted to be between \$1,000 and \$4,000 and is based on an analysis of rates charged by other comparable arenas for the types of events forecasted. Management does not anticipate an increase in ticket prices or flat rate rentals during the second year of operations.

Parking Fees. Management will operate and maintain the parking facility and, accordingly, all revenues accrue to MARS Arena. Consistent with experience at the City's existing arena, management estimates that 75 percent of all patrons will arrive by car for each event. The forecasted information assumes each car will carry an average of 2.7 persons and average parking rates will be \$3.50 per car.

Food and Beverage Concessions. Management has negotiated a contract with ABC Company to supply and manage the food and beverage concessions. Concession income is forecasted to be 30 percent of gross concession revenue generated at each event, based on the contractual agreement with ABC Company. MARS Arena will provide all equipment and personnel necessary to operate the concessions. Patron's forecasted average expenditure per type of event ranges from \$0.75 to \$3.00 and is based on an analysis of data for comparable events and facilities, including the City's existing arena.

Novelty and Souvenir Income. Similar to food and beverage concessions, management has negotiated a contract with ABC Company to supply and manage the novelty and souvenir concessions. Novelty and souvenir income is forecasted to be 30 percent of gross novelty revenue based on the contractual agreement. MARS Arena will provide all equipment and personnel necessary to operate the novelty and souvenir stands. Patron's forecasted average expenditure per type of event ranges from \$0.00 to \$5.25 and is based on an analysis of data for comparable events and facilities.

Advertising. Advertising income will be generated primarily from signage on the interior and exterior of MARS Arena. Revenues included in the forecasted information are based on the signage capacity of MARS Arena, contract negotiations to date, and advertising revenues at the City's existing arena.

D. Salaries and Wages

The forecasted information assumes that management will make maximum use of full-time staff rather than subcontract out services, such as facility management and security. Personnel requirements are based on staffing organizations at similar sports arenas and public assembly facilities. Pay for hourly workers is based on local wage levels and wage rates being paid to employees of the City's existing arena. Wage levels are expected to increase approximately 4 percent in the second year.

Salaries are forecasted on an individual by individual basis using expected salary rates during the forecast period. Part-time salaries and wages are assumed to be event-related expenses and passed through to tenants, except for 15 percent, which is absorbed by MARS Arena.

E. Office and General Expenses

Office and general expenses consist of insurance, advertising, fees for services, and other office and general expenses. Insurance expense is based on costs at the City's existing arena and a review of insurance coverage proposals that include estimates of general liability, fire, workers' compensation, auto-business, liquor liability and boiler-machinery coverage. Advertising expenses are based on costs incurred by the City's existing arena, the number and type of forecasted events, and expected price increases from advertising agencies. Advertising expenses are expected to be higher in the first year of operations in order to promote the new facility. Fees for services include, but are not limited to, consulting fees, legal fees, and accounting and auditing fees. These fees are estimated based on expenses of the City's existing arena and plans by management to engage consultants to assist in starting up operations. Other office and general expenses are based on experience at comparable facilities and on costs incurred by the City's existing arena.

F. Utilities

Utility expense has been estimated by the project team architects and engineers. Utilities expense includes fuel and gas, electricity, water, and sewer costs.

G. Operations and Maintenance Expenses

Operations and maintenance expenses were estimated based on the requirements of facilities similar in construction and design, age, and intended use.

**Forecasts and Projections Task Force
(1989)**

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Auditing Standards
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Auditing Standards

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Section 11,160

Statement of Position 90-2 Report on the Internal Control Structure in Audits of Futures Commission Merchants

February, 1990

NOTE

This statement of position presents the recommendations of the AICPA Stockbrokerage and Investment Banking Committee regarding the application of generally accepted auditing standards to reporting on the internal control structure in audits of futures commission merchants. It represents the considered opinion of the committee on the best auditing practice in the industry and has been reviewed by members of the AICPA Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this statement if their work is challenged.

Introduction

[.01-.02] [Paragraphs deleted to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

Report on Internal Control Required by CFTC Regulation 1.16

.03 The following is an illustration of the independent auditor's report on the internal control structure required by CFTC Regulation 1.16:

Board of Directors
ABC Commodities Corporation

In planning and performing our audit of the consolidated financial statements of ABC Commodities Corporation (the "Corporation") for the year ended December 31, 19X1, we considered its internal control structure, including procedures for safeguarding customer and firm assets, in order to determine our auditing procedures for the purpose of expressing our opinion on the consolidated financial statements and not to provide assurance on the internal control structure.

Also, as required by Regulation 1.16 of the Commodity Futures Trading Commission, we have made a study of the practices and procedures (including tests of compliance with such practices and procedures) followed by the Corporation that we considered relevant to the objectives stated in Regulation 1.16

* Statement on Auditing Standards (SAS) No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, revises the definition and description of internal control and makes conforming changes to relevant terminology. This SOP will be amended to conform to SAS No. 78 in a future edition of *Technical Practice Aids*.

in making (1) the periodic computations of minimum financial requirements pursuant to Regulation 1.17, (2) the daily computations of the segregation requirements of section 4d(2) of the Commodity Exchange Act and the regulations thereunder, and the segregation of funds based on such computations, and (3) the daily computations of the foreign futures and foreign options secured amount requirements pursuant to Regulation 30.7 of the Commission.

The management of the Corporation is responsible for establishing and maintaining an internal control structure and the practices and procedures referred to in the preceding paragraph. In fulfilling this responsibility, estimates and judgments by management are required to assess the expected benefits and related costs of internal control structure policies and procedures and of the practices and procedures referred to in the preceding paragraph and to assess whether those practices and procedures can be expected to achieve the Commission's above mentioned objectives. Two of the objectives of an internal control structure and the practices and procedures are to provide management with reasonable, but not absolute, assurance that assets for which the Corporation 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. Regulation 1.16 lists additional objectives of the practices and procedures listed in the preceding paragraph.

Because of inherent limitations in any internal control structure or the practices and procedures referred to above, errors or irregularities may occur and not be detected. Also, projection of any evaluation of them to future periods is subject to the risk that they may become inadequate because of changes in conditions or that the effectiveness of their design and operation may deteriorate.

Our consideration of the internal control structure would not necessarily disclose all matters in the internal control structure that might be material weaknesses under standards established by the American Institute of Certified Public Accountants. A material weakness is a condition in which the design or operation of the specific internal control structure elements does not reduce to a relatively low level the risk that errors or irregularities in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. However, we noted no matters involving the internal control structure, including procedures for safeguarding customer and firm assets, that we consider to be material weaknesses as defined above.¹

We understand that practices and procedures that accomplish the objectives referred to in the second paragraph of this report are considered by the Commission to be adequate for its purposes in accordance with the Commodity Exchange Act and related regulations, and that practices and procedures that

¹ If conditions believed to be material weaknesses are disclosed, the report should describe the weaknesses that have come to the auditor's attention and may state that these weakness do not affect the report on the financial statements. The last sentence of the fifth paragraph of the report should be modified as follows:

However, we noted the following matters involving the [(control environment, accounting system, control procedures, or procedures for safeguarding customer and firm assets)] and its [(their)] operation that we consider to be material weaknesses as defined above. These conditions were considered in determining the nature, timing, and extent of the procedures to be performed in our audit of the consolidated financial statements of the Corporation for the year ended December 31, 19X1, and this report does not affect our report thereon dated February 15, 19X2. [A description of the material weaknesses that have come to the auditor's attention and corrective action would follow.]

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 Corporation's practices and procedures were adequate at December 31, 19X1, to meet the Commission's objectives.²

This report is intended solely for the use of management, the Commodity Futures Trading Commission, and other regulatory agencies that rely on Regulation 1.16 of the Commodity Futures Trading Commission and should not be used for any other purpose.

Accounting Firm

New York, New York
February 15, 19X2

Effective Date

.04 This statement is effective for reports issued on or after March 1, 1990, with early application permissible.

² Whenever inadequacies are described, the report should include the last sentence of the fifth paragraph as modified in the note above. The report should also describe material inadequacies 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 CFTC.

**Stockbrokerage and Investment Banking Committee
(1989-1990)**

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Section 11,220

Statement of Position 92-2 Questions and Answers on the Term Reasonably Objective Basis and Other Issues Affecting Prospective Financial Statements

February, 1992

NOTE

This Statement of Position presents the recommendations of the Forecasts and Projections Task Force regarding accountants' services on prospective financial information. It also includes recommendations regarding presentation and disclosure of prospective financial information. AICPA members may have to justify departures from the recommendations in this Statement of Position if their work is challenged.

Responsible Party's Basis for Presenting a Financial Forecast

Question

.01 Paragraph 7.03 of the *AICPA Guide for Prospective Financial Statements* (the Guide) requires a responsible party to have a reasonably objective basis for presenting a financial forecast.¹ What is the purpose of the term *reasonably objective basis*?

Answer

.02 Financial forecasts are presentations of information about the future and are inherently less precise than information reporting past events. That "softness" of forecasted data is communicated to users of financial forecasts in the introduction to the summary of significant assumptions by including a caveat that the forecasted results may not be achieved.² Nevertheless, financial forecasts present, to the best of the responsible party's knowledge and belief, the entity's expected financial position, results of operations, and changes in financial position (cash flows).

.03 Because users expect financial forecasts to present the responsible party's "best estimate," the term *reasonably objective basis* was included in the Guide to communicate to responsible parties a measure of the quality of information necessary to present a forecast.

¹ This guidance applies only to financial forecasts. As discussed in paragraph 7.01P of the Guide, the responsible party does not need a reasonably objective basis for hypothetical assumptions used in a financial projection. However, this guidance should be useful in evaluating whether other assumptions used provide a reasonable basis for a projection, given the hypothetical assumptions.

² Paragraph 8.29 of the Guide illustrates the type of caveat to be included: "There will usually be differences between the forecasted and actual results, because events and circumstances frequently do not occur as expected, and those differences may be material."

Question

.04 In addition to establishing the term *reasonably objective basis*, the Guide indicates that the responsible party should develop appropriate assumptions to present a financial forecast (see paragraphs 6.30 through 6.36 of the Guide). How does a responsible party evaluate whether a reasonably objective basis exists for a financial forecast and whether the assumptions underlying a particular forecast are appropriate?

Answer

.05 Considerable judgment is required to evaluate whether a reasonably objective basis exists to present a financial forecast. Accordingly, the responsible party should possess or obtain a sufficient knowledge of the reporting entity's business and industry to make the evaluation.

.06 Paragraph 4.07 of the Guide states that the responsible party has a reasonably objective basis for presenting a financial forecast if sufficiently objective assumptions can be developed for each key factor. (Paragraph 3.11 of the Guide defines *key factors* as the significant matters on which the entity's future results are expected to depend. Such factors are basic to the entity's operations and, thus, encompass matters that affect, among other things, its sales, production, service, and financing activities.) The following matters should be considered when evaluating whether such assumptions can be developed:

- Can facts be obtained and informed judgments be made about past and future events or circumstances in support of the underlying assumptions?
- Are any of the significant assumptions so subjective that no reasonably objective basis could exist to present a financial forecast?³
- Would people knowledgeable in the entity's business and industry select materially similar assumptions?
- Is the length of the forecast period appropriate?⁴

Other matters that responsible parties should consider when evaluating whether sufficiently objective assumptions can be developed are shown in the exhibit [paragraph .08].

.07 The evaluation of whether sufficiently objective assumptions can be developed for each key factor should be made within the following context:

- A factor is evaluated by considering its significance to the entity's plans as well as the dollar magnitude and pervasiveness of the related assumption's potential effect on forecasted results (for example, whether assumptions developed would materially affect the amounts and presentation of numerous forecasted amounts).
- The responsible party's consideration of which key factors have the greatest potential impact on forecasted results is a matter of judg-

³ For example, the responsible party might have no reasonably objective basis for presenting a forecast that includes royalty income from products not yet invented or revenue from a thoroughbred being reared to race. In such cases, it would be inappropriate to present a forecast because of the lack of a reasonably objective basis.

⁴ See paragraphs .44 through .46 of this Statement of Position (SOP).

ment, and is influenced by his or her perception of the needs of a reasonable person relying on the financial forecast. A key factor having the greatest potential impact on forecasted results is one in which an omission or misstatement of the related assumption would probably, in light of surrounding circumstances, change or influence the judgment of a reasonable person relying on the financial forecast.⁵

- The responsible party should seek out the best information that is reasonably available to develop the assumptions. Cost alone is an insufficient reason not to acquire needed information. However, the cost of incremental information should be commensurate with the anticipated benefit.
- A conclusion that a reasonably objective basis exists for a forecast may be easier to support if the forecast were presented as a range.

⁵ The more likely it is that an assumption will have a significant effect on the overall forecasted results and that the factors relating to the assumption indicate a less objective basis, the more likely it is that the forecast should be judged as not having a reasonably objective basis.

.08

Exhibit

Sufficiently Objective Assumptions—Matters to Consider

<i>Basis</i>	<i>Less Objective</i>	<i>More Objective</i>
Economy	Subject to uncertainty	Relatively stable
Industry	Emerging or unstable; high rate of business failure	Mature or relatively stable
Entity:		
• Operating history	Little or no operating history	Seasoned company; relatively stable operating history
• Customer base	Diverse, changing customer group	Relatively stable customer group
• Financial condition	Weak financial position; poor operating results	Strong financial position; good operating results
Management's experience with:		
• Industry	Inexperienced management	Experienced management
• The business and its products	Inexperienced management; high turnover of key personnel	Experienced management
Products or services:		
• Market	New or uncertain market	Existing or relatively stable market
• Technology	Rapidly changing technology	Relatively stable technology
• Experience	New products or expanding product line	Relatively stable products
Competing assumptions	Wide range of possible outcomes	Relatively narrow range of possible outcomes
Dependency of assumptions on the outcome of the forecasted results *	More dependency	Less dependency

* Assumptions may depend on the achievement of other forecasted results. For example, the sales price of a real estate property in a forecast might be estimated by applying a capitalization rate to forecasted cash flows.

.09 As stated earlier, in addition to requiring a reasonably objective basis, the Guide requires a responsible party to develop appropriate assumptions to present a financial forecast. When evaluating whether assumptions underlying the financial forecast are appropriate, the responsible party should consider numerous factors, including whether—

- There appears to be a rational relationship between the assumptions and the underlying facts and circumstances (that is, the assumptions are consistent with past or current conditions).
- The assumptions are complete (that is, assumptions have been developed for each key factor).
- It appears that the assumptions were developed without undue optimism or pessimism.
- The assumptions are consistent with the entity's plans and expectations.
- The assumptions are consistent with each other.
- The assumptions, in the aggregate, make sense in the context of the forecast taken as a whole.

Assumptions that have no material impact on the presentation may not have to be evaluated individually; however, the aggregate impact of individually insignificant assumptions should be considered in making an overall evaluation of whether the assumptions underlying the forecast are appropriate.

.10 The following examples illustrate the facts and circumstances considered by the responsible party when evaluating whether there was a reasonably objective basis to present a financial forecast.

Example 1

Company Profile

.11 An established builder of single-family homes has built two garden-apartment complexes in the last three years. This developer plans to build another garden-apartment complex and wishes to syndicate the project. Both of the existing garden-apartment complexes are approaching full occupancy. The local economy is strong and has a diversified base. Furthermore, real estate in the area generally appreciates in value. There has been significant development in the area and, if it continues, supply will exceed demand within four years. The developer has appropriately considered this factor, as well as the associated cost of maintaining the proposed facility, in planning the project and developing the forecast.

.12 In the past, the developer had financed each of his projects for five years at the maximum amount allowed by local financial institutions. Forecasts for the previous two projects assumed a five-year financing period and a hypothetical sale of the property at the end of the forecast period. For the proposed development, the developer has obtained a commitment for a three-year interest-only loan for an amount equal to 70 percent of the project's estimated cost. Current discussions with bankers have indicated their willingness to convert that loan to long-term financing for the project after rental stabilization, which is consistent with normal lending practices. The developer

has indicated that he plans to refinance the committed loan after three years for an amount that exceeds the loan by approximately 76 percent. Such additional amounts (net of refinancing costs) are to be returned to the investors as a cash distribution. The developer's other resources are not sufficient to provide a meaningful guarantee of the refinancing. The forecast will be for five years, and will include a projection illustrating a hypothetical sale at the end of the forecast period. The details can be summarized as follows:

	<i>(In thousands)</i>
• Estimated cost of the development to the partnership	<u>\$10,000</u>
• Committed financing (interest-only loans) at 70 percent of the estimated cost	<u>\$ 7,000</u>
• Proposed limited partnership investment	<u>\$ 3,000</u>
• Amount of proposed refinancing:	
— Long-term refinancing of the three-year committed loan	\$ 7,000
— Additional financing for payments to limited partners	5,000
— Cost of refinancing	300
	<u>\$12,300</u>
• Forecasted cash flow before debt service for the fourth year	<u>\$ 1,500</u>
• Capitalization rate (considered in this example to be acceptable under the circumstances)	<u>9%</u>
• Capitalized value at the end of the third year	<u>\$16,700</u>

Question

.13 Does the developer (the responsible party) have a reasonably objective basis for forecasting the proposed refinancing?⁶

Answer⁷

.14 This question can be divided into two further questions:

- a. Can the developer forecast a refinancing?
- b. Are the assumptions about the amount and terms of the refinancing sufficiently objective?

.15 *Forecast of Refinancing.* The developer has obtained a financing commitment for three years based on local lending practices, and bankers have indicated a willingness to provide permanent financing in a manner that is consistent with these lending practices. Accordingly, it appears that the developer would have a reasonably objective basis for forecasting the project's refinancing for a comparable amount in three years.⁸ At that time, the building

⁶ See paragraphs .57 and .58 of this SOP for a discussion of the responsibility that an accountant engaged to compile or examine a financial forecast has to evaluate whether a responsible party has a reasonably objective basis for presenting a financial forecast.

⁷ This response is based on information presented in the question. Other information, such as that about the size and strength of the local economy, the precise location of the project, local planning regulations, and the availability of third-party guarantees on the proposed refinancing, could change the response.

⁸ Support for forecasted interest rates may exist in the form of interest-rate forecasts and current interest-rate trends. If interest-rate fluctuations are a concern, a conclusion that sufficiently objective interest assumptions could be developed may be easier to support if forecasted results are presented as a range (through the use of a range forecast).

will still be considered relatively new and, based on maintenance plans, should be in good condition. Further, real estate in the area generally is expected to appreciate in value, and forecasted cash flows before debt service are consistent with a refinancing assumption.

.16 *Amount and Terms of Refinancing.* Although the developer may have a reasonably objective basis for a forecast that includes a refinancing for an amount approximating the original loan, it is not clear that such a basis exists for one that includes a refinancing significantly in excess of that amount. The following factors should be considered:⁹

- Although the local economy is strong and diversified, competing developments are being built and, in fact, there is some risk that supply could exceed demand.
- The developer has factored the effect of an increase in the supply of competing housing units into the forecast and may point to an estimated value of the project at the end of the third year, based on the application of a current capitalization rate to forecasted cash flows. However, capitalization rates may vary over time, and estimated values derived from the application of capitalization rates depend on the achievement of prospective cash flows.
- The developer is an experienced builder; however, both his experience with larger projects and his resources are limited.

.17 In light of the facts presented, it appears that the developer's basis for refinancing the project at an amount significantly greater than the original loan would be highly dependent on future events and circumstances, such as anticipated cash flows, economic conditions, lending practices, and capitalization rates. Although forecasted results may be used as a basis for a refinancing assumption, in the absence of other supporting information, such results ordinarily would not provide a responsible party with a basis for concluding that the refinancing assumption was sufficiently objective. In this case, the developer's limited resources and the length of time until the refinancing is expected to take place are all risk factors that mitigate a reliance on forecasted results to provide support for the developer's assertion that a reasonably objective basis exists for the refinancing. Accordingly, in the absence of additional information, the facts in this case do not appear to support the developer's assertion that a reasonably objective basis exists for presenting a forecast that includes the proposed refinancing assumption.¹⁰

Example 2

Company Profile

.18 ACTech, Inc. was established to produce a line of flat-panel, AC-plasma computer-display products for use when, because of their bulk and thickness, cathode-ray tubes (CRTs) would not be suitable. The company was incorporated in 19X0 by former members of a management team (the founders) who designed the product and operated the business as a division of BigCo. The

⁹ These items were developed by reference to the factors included in the exhibit [paragraph .08].

¹⁰ In this example, the developer could consider including a refinancing for the committed amount (\$7,000,000) in the forecast, and supplementing the forecast with a financial projection illustrating prospective results if the permanent financing obtained were for the greater amount (\$12,300,000).

founders have purchased equipment and certain technology at a significant discount from BigCo with \$1 million in funds raised from private investors. ACTech's goal is to become a leader in the production and sale of AC-plasma-display products by utilizing newly developed but unproven technology to lower the cost of production and thereby compete more effectively with DC-plasma-display products. DC products are currently in common usage because of their lower unit cost, but they are inferior to AC-plasma-display products in brightness and resolution.

.19 Product Line and Competition. The mainstay of the ACTech product line will be a "plasma display system," which combines the AC-plasma-display panels with new low-cost drive circuitry. When compared to the most competitive product, the DC-plasma-display, ACTech's product is three times as bright with no flicker, consumes half the power for an equivalent level of light output, has a wider viewing angle, can be produced in much larger sizes, and has a longer life. DC panels are currently cheaper to produce, but with ACTech's circuitry and manufacturing expertise, management hopes to close the cost gap. ACTech is currently working on the implementation of its new technology. Prototypes have been successfully produced, but management estimates that, using the equipment purchased from BigCo, it will need about a year to design and install a high-volume production line.

.20 Competition from other AC-plasma-display manufacturers will come primarily from ACpan, a very large manufacturer that uses most of its output in its own products. ACpan AC-plasma displays have been available for the past five years and are comparable in quality to those of ACTech. Despite continued efforts, ACpan has achieved very little market penetration because, like ACTech and other producers of AC-plasma-displays, ACpan has not been able to successfully design and install a high-volume production line. If successfully developed, ACTech's manufacturing process and the low-cost drive circuits will permit it to compete advantageously with ACpan. Other manufacturers of AC-plasma-displays charge prices that are higher than those of the ACpan products and cater to military and specialty markets. In the market for large-sized screens, management believes that there is no effective flat-panel competition.

.21 Additionally, ACTech has received oral assurances from BigCo that it will purchase plasma displays from ACTech in sufficient quantities to meet its needs, which would account for about 5 percent of ACTech's estimated sales.

.22 Sales and Marketing. ACTech will sell primarily to equipment manufacturers via an internal sales force. Additionally, ACTech will utilize manufacturer's representatives or sales organizations to penetrate selected foreign markets. ACTech's products will be demonstrated at various trade shows and will be advertised in the appropriate trade journals.

.23 ACTech has targeted specific markets for its primary growth. These markets include those for (a) mainframe interactive applications (ACTech, when it was a division of BigCo, had already established a small market in this area), (b) portable personal computers (ACTech is currently involved in discussions with several large companies in this market), (c) CAD/CAM/CAE workstations (ACTech is currently involved in discussions with producers serving both financial and design markets), and (d) manufacturing control products (ACTech is working with a company that uses a plasma panel with a touch screen to support the manufacturing process).

.24 ACTech has estimated sales of approximately \$600,000 in 19X2, \$16 million in 19X3, and \$40 million in 19X4. At anticipated levels of industry growth (provided from an outside source), these sales figures represent 0.3 percent, 6 percent, and 11 percent of the plasma-panel market, respectively.

.25 *Product Manufacture.* Management believes that the equipment purchased from BigCo by the founders is state of the art. ACTech is in the process of relocating the equipment to a new facility and setting up a modern, automated production line. This new facility, which requires some renovation, will allow ACTech to begin production on a limited scale in about six months. Ample room exists for future expansion. No significant problems are expected in relocating and setting up the new facility, assuming that design problems related to high-volume production can be overcome.

.26 Production is expected to be at 500 AC-plasma display-system units in 19X2, growing to 36,000 in 19X3 and 115,000 in 19X4.

.27 *Management and Personnel.* The ACTech management team is recognized throughout the computer industry as a leader in plasma-display technology and manufacturing. Together, the four founders have over fifty years of experience in the field of flat-panel displays. Additionally, the founders have demonstrated significant academic and manufacturing achievements in the field of display technology. At present, ACTech has three full-time and eleven part-time employees. Management plans to hire an additional thirty-five employees during 19X2, including three marketing and sales employees.

.28 Management expects employment to grow to about 250 by 19X4. Although production employees must be hired and trained, the labor market is sufficient to supply an adequate labor force with the basic technical skills needed to perform the required tasks, and management has experience in training. Further, management has had discussions with several candidates for the sales positions and does not anticipate difficulties in hiring qualified staff.

Question

.29 Does management have a reasonably objective basis for presenting a financial forecast?¹¹

Answer¹²

.30 ACTech, Inc.'s financial forecast is based on two primary assumptions: (a) the successful design and installation of a high-volume production line, which would enable the company to significantly reduce unit costs; and (b) the timing and quantity of sales.

.31 *High-Volume Production.* ACTech is planning to manufacture and sell AC-plasma-display products for use in computer terminals. Its success will be highly dependent on its ability to produce those products in large quantities for sale at a price competitive with DC-plasma products. Although prototypes of the company's products have been produced, circuitry compatible with high-

¹¹ See footnote 6 of this SOP.

¹² This response is based on information presented in the question. Other information about the status of engineering plans, the preproduction models, and marketing results could change the response. The response was developed by referring to the factors included in the exhibit [paragraph .08].

volume production has been developed, and experienced management has been hired, the company has yet to design and install the planned high-volume production line. As indicated previously, management's current estimate is that it will be at least twelve months before that work is completed. Further, the facts presented indicate that other manufacturers of AC-plasma-display units have not been successful in reducing production costs. BigCo's willingness to sell its AC-plasma-display division may also indicate uncertainty about its ability to reduce production costs.

.32 For the reasons discussed in the preceding paragraph, management's assumption that it will be able to achieve high-volume, low-cost production is relatively subjective. That assumption is critical to the company's sales assumptions, which depend on the reduction of production costs to a level that permits a pricing structure competitive with that of DC-plasma units. Without a competitive pricing structure, the company's sales assumptions do not appear to be valid. Accordingly, ACTech does not appear to have a reasonably objective basis for presenting a financial forecast.

.33 *Other Matters.* If the feasibility of establishing a high-volume production line capable of producing AC-plasma units at a cost that permits ACTech to competitively price its product could be reasonably assured, a reasonably objective basis might exist for presenting a financial forecast. Before that conclusion can be reached, consideration should be given to ACTech's assumptions regarding market penetration. ACTech has developed a sales and marketing plan; however, questions exist concerning its assumptions of an aggressive market penetration (for example, capturing 11 percent of the plasma-panel market by the end of 19X4). There are several factors that appear to support its sales assumption: the technological superiority of its products, competitive pricing, management's experience with the products, and the acceptability of the product to current users, such as BigCo. Nevertheless, it would be appropriate to gather additional information concerning marketing results to date before concluding whether a sufficiently objective basis exists for the assumptions regarding market penetration. Further, uncertainty concerning the company's sales assumptions may indicate that such assumptions would be easier to support if a range forecast were presented. (Exhibit 8.09 of the Guide illustrates a range forecast.)

Example 3

Company Profile

[Note: As indicated in paragraph .46 of this SOP, it may be difficult to support an assertion that a reasonably objective basis exists for presenting a financial forecast for certain start-up companies. The following example illustrates a situation in which a two-year forecast for a start-up company may be appropriate.]

.34 Newco was established to manufacture wall panels with self-contained insulation for use in commercial and industrial projects. The panels provide a lightweight interior and exterior wall combination. The company was incorporated in 19X0 by a former executive of one of the leaders in the wall-panel market, and by an individual who helped develop the original technology ten years ago (the founders). The founders have invested \$1,000,000, which was used to order initial equipment and lease a building. Newco has sufficient capital to operate during the forecast period.

.35 Although more expensive than those using traditional materials, the panels have proven to be easier to install than rolled or blown-in insulation and

wall surface combinations. Therefore, the use of the insulated wall panels in construction has been increasing. Competitors in the wall-panel market include two divisions of publicly held corporations that produce the panels, along with a variety of other construction materials, in a number of plants. These competitors generally service the large-project market and are known to have significant backlogs. From interviews with industry sources, it has been determined that these companies have been unable to respond to small or rush orders. Newco believes that, as an entrepreneurial company having low overhead and specializing in one product, it can service the small-order market effectively and profitably.

.36 Sales would be generated through bid contracts advertised by a clearinghouse that provides information to contractors and through the establishment of long-term relationships with engineering and architectural professionals. After lengthy correspondence with these professionals, Newco has obtained commitments for approximately 5 percent of its production capacity for 19X1 and 19X2 (about 25 percent and 15 percent of forecasted sales in 19X1 and 19X2, respectively). In addition, the initial equipment installation has allowed Newco to respond to selected advertised bids and obtain contracts for one-third of the opportunities pursued. These contracts account for 10 to 12 percent of the plant's capacity and extend through 19X2 (representing 50 percent and 35 percent of forecasted sales in 19X1 and 19X2, respectively). Newco plans to expand its sales force to enable it to respond to additional opportunities.

.37 In estimating its sales, Newco considered the growth in the construction market, the increasing conversion to manufactured wall panels, its success rate in bidding opportunities, the planned growth in its sales force, and the number of orders received to date. Newco has estimated sales of approximately 20 and 33 percent of production capacity in 19X1 and 19X2, respectively. These sales figures would represent market shares of 2 to 3 percent of the bid market for insulated wall panels. In addition to clearinghouse data used to assess market growth and size, management has considered industry sources that provide significant information on construction and usage potentials in making its sales estimates.

.38 The application of the technology involved in the production process continues to serve as a deterrent to entering the small-order market. Newco's initial investment has allowed for limited-scale production, and no significant problems are expected in obtaining the additional equipment and achieving forecasted capacity. Further, the company has been able to manufacture a quality product within its range of estimated costs.

.39 The founders are recognized within the industry for their technological and manufacturing expertise. Management has hired financial and production management executives, and is in the process of making its selection of three additional salespeople from a number of candidates experienced in the industry. Although additional production employees must be hired and trained, the labor market is sufficient to supply an adequate labor force with the basic technical skills needed to perform the required tasks.

Question

.40 Does management have a reasonably objective basis for presenting a financial forecast for 19X1 and 19X2?¹³

¹³ See footnote 6 of this SOP.

Answer¹⁴

.41 Yes. Given the facts in this case, it appears that Newco has a reasonably objective basis for forecasting its operations for the years 19X1 and 19X2.

.42 Newco's product currently exists in the market and represents a technologically proven alternative that competes with similar technologies and alternatives based upon price. Further, the quality of its production and costs incurred to date have been in line with management's expectations. Accordingly, Newco's ability to forecast operating results depends on the primary assumption of the timing and quantity of sales.

.43 Management's ability to identify competitors, analyze customers' buying motives, and evaluate the market as well as the potential end usage demand are important determinants in forecasting sales. However, it is management's demonstrated success in identifying and establishing a specific customer base and in establishing a bidding track record that provides an important validation of its assessments of competition, pricing, and industry practices; it also provides the basis for management's sales forecast capabilities. Current contracts and commitments would account for a substantial portion of forecasted sales for 19X1 and 19X2, and the company's bidding success rate, coupled with the imminent hiring of experienced sales personnel, appears to provide a basis for estimated increases in sales during those years.

Consideration of the Length of the Forecast Period

Question

.44 In practice, financial forecasts have been presented for various periods of time, some of which exceed ten years. What factors should be considered in determining the time period to be covered by a financial forecast?

Answer

.45 The Guide does not specify any fixed minimum or maximum time period to be covered by a financial forecast. The period that appropriately may be covered depends to a large extent on the particular circumstances of the company involved.¹⁵ In evaluating the period to be covered by a forecast, the responsible party should balance the information needs of users with his or her ability to estimate prospective results; however, a reasonably objective basis should exist for each forecasted period (month, quarter, or year) presented.¹⁶

.46 In order to be meaningful to users, the presentation of a financial forecast ordinarily should cover at least one full year of normal operations.^[17] However, the degree of uncertainty generally increases with the time

¹⁴ This response is based on information presented in the question. Other information, such as that about the economy and its effect on Newco's industry and its forecasted results, could change this response. The response was developed by reference to the factors included in the exhibit [paragraph .08].

¹⁵ SEC Regulation S-K, 229.10(b)(2) states that, for certain companies in certain industries, a (forecast) covering a two- or three-year period may be entirely reasonable. Other companies may not have a reasonable basis for (forecasts) beyond the current year. Accordingly, the responsible party should select the period most appropriate in the circumstances.

¹⁶ See question entitled "Periods Covered by an Accountant's Report on Prospective Financial Statements," included in SOP 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements* [section 11,110.21 through .23].

^[17] [Deleted.]

span of the forecast, and at some point, the underlying assumptions may become so subjective that no reasonably objective basis may exist for presenting a financial forecast. It ordinarily would be difficult to establish that a reasonably objective basis¹⁸ exists for a financial forecast extending beyond three to five years,¹⁹ and depending on the circumstances, a shorter period may be appropriate (for example, in the case of certain start-up or high-tech companies it may be difficult to support an assertion that a reasonably objective basis exists to present a financial forecast and, if so, for more than one year). If it is not practical to present a financial forecast for enough future periods to demonstrate the long-term results of an investment or other decision, the presentation should include a description of the potential effects of such results.²⁰

Disclosure of Long-Term Results

Question

.47 Paragraph 8.34 of the Guide states that short-term forecasts may not be meaningful in situations in which long-term results are necessary to evaluate the investment consequences involved. However, because uncertainty generally increases with the time span, it may not be practical in all situations to present financial forecasts for enough future periods to demonstrate long-term results.²¹ In those circumstances, the presentation should include a description of the potential effects of such results. What form of disclosure would be appropriate in such circumstances when a financial forecast for general use will be presented?

Answer

.48 The Guide does not provide a standard format for disclosures²² intended to demonstrate operating or other results beyond the forecast period (that is, post-forecast-period disclosures),²³ because it is not possible to anticipate all the circumstances that might arise in practice. However, such disclosures should be based on the responsible party's plans and knowledge of specific events or circumstances, at the date of the forecast, that are expected to have a material effect on results beyond the forecast period.

.49 Specific plans, events, or circumstances that might be disclosed include the following:

¹⁸ See paragraphs .01 through .43 of this SOP for a discussion of factors to be considered when evaluating whether a reasonably objective basis exists to present a financial forecast.

¹⁹ Financial forecasts for longer periods may be appropriate, for example, when long-term leases or other contracts exist that specify the timing and amount of revenues, and when costs can be controlled within reasonable limits.

²⁰ See paragraph 8.34 of the Guide and paragraphs .47 through .56 of this SOP.

²¹ See paragraphs .44 through .46 of this SOP for a discussion of matters to consider when evaluating the length of a forecast period.

²² Exhibit 9.10 of the Guide illustrates a disclosure that is appropriate for describing long-term results of certain real estate projects. That illustration includes a projection that discloses the effect on limited partners of a hypothetical sale of the property at the end of the forecast period.

²³ Paragraph 4.05 of the Guide states that "because a financial projection is not appropriate for general use, it should not be distributed to those who will not be negotiating directly with the responsible party . . . unless the projection is used to supplement a financial forecast and is for a period covered by the forecast." A financial projection is defined in paragraph 3.05 of the Guide as prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position (cash flows), given one or more hypothetical assumptions.

- Scheduled increases in loan principal
- A planned refinancing
- Existing plans for future expansion of production or operating facilities or for the introduction of new products
- Expiration of a significant patent or contract
- The expected sale of a major portion of an entity's assets²⁴
- Scheduled or anticipated taxes that have adverse consequences for investors

.50 Disclosures may be limited to a narrative discussion of the responsible party's plans, or they may include estimates of expected effects of future transactions or events. In all cases, however, the disclosure should be included in, or incorporated by a reference to, the summary of significant assumptions and accounting policies. It should also—

- Include a title indicating that it presents information about periods beyond the financial forecast period.
- Include an introduction indicating that the information presented does not constitute a financial forecast and indicating its purpose.
- Disclose significant assumptions and identify those that are hypothetical, as well as the specific plans, events, or circumstances that are expected to have a material effect on results beyond the forecast period.
- State that (a) the information is presented for analysis purposes only, (b) there is no assurance that the events and circumstances described will occur, and (c) if applicable, the information is less reliable than the information presented in the financial forecast.

.51 The purpose of the disclosures discussed herein is to provide users with additional information useful in analyzing forecasted results. However, the information relates to periods beyond the forecast period, and management generally does not have a reasonably objective basis for presenting it as forecasted information. Accordingly, the disclosures are less reliable than those that are included in a financial forecast. Such disclosures should not be presented comparatively to forecasted results on the face of the financial forecast or in related summaries of results (for example, in a summary of investor benefits), or as a financial projection,²⁵ since such presentations could be misleading. The following examples illustrate the types of disclosures that may be appropriate.

Example 1

*Note A: Supplemental Information Related to the Three Years Ending December 31, 19X8*²⁶

²⁴ See footnote 22 of this SOP.

²⁵ Paragraph 3.05 of the Guide provides the definition of a financial projection. Paragraph 4.05 states that a financial projection is not appropriate for general use unless it supplements a financial forecast and is for a period covered by the forecast. SOP 89-3, *Questions Concerning Accountants' Services on Prospective Financial Statements* [section 11,110], provides guidance for reporting on a projection that supplements a financial forecast and is for a period covered by the forecast.

²⁶ See exhibit 9.10 of the Guide and SOP 89-3 [section 11,110] for an alternate presentation of long-term results when a projection is used to supplement a financial forecast and is for a period covered by the forecast (for example, the projected sale of real estate on the last day of the forecasted period).

While management is unable to prepare a financial forecast for the three-year period ending December 31, 19X8, it believes that the following information is necessary for users to make a meaningful analysis of the forecasted results.

Management's forecast anticipates operation of each of the three properties described therein during the five-year period ending December 31, 19X5. Current plans are to continue operation of all three properties through December 31, 19X8, at which time the properties will be offered for sale. The following table illustrates the pre-tax effect to limited partners of a sale of properties at December 31, 19X8, and the subsequent liquidation of the partnership. The table is based on the following hypothetical assumptions:²⁷

- Column A is based on the assumption that the property will be sold (or foreclosed) for the balance of the mortgage notes at December 31, 19X8.
- Columns B and C are based on the assumption that the properties will be sold at estimated market values, which are calculated by capitalizing estimated cash flows from operations for the year immediately preceding the sale at rates of 7 percent and 9 percent, respectively.
- The estimated balance of outstanding mortgage notes at December 31, 19X8, is based on the assumption that the partnership will continue to make payments in accordance with existing terms of the mortgage notes. Note 7 to the financial forecast describes the partnership's outstanding mortgage notes and related payment terms.
- Management has estimated net operating cash flow (in total and per unit) for the three years ending December 31, 19X8, using assumptions substantially the same as those used in its financial forecast for the five years ending December 31, 19X5. In preparing the estimate, 19X5 forecasted rental income and forecasted operating expenses and management fees were increased by 5 percent per year.

	<u>A</u>	<u>B</u>	<u>C</u>
	<i>Sale for Existing Mortgage Balance</i>	<i>Sale at a 7% Capitalization Rate</i>	<i>Sale at a 9% Capitalization Rate</i>
Cash distributions to limited partners:			
For the forecast period	\$XXX	\$XXX	\$XXX
For the three-year period ending December 31, 19X8	XXX	XXX	XXX
Net from sale and dissolution	XXX	XXX	XXX
Less original capital contribution	(XXX)	(XXX)	(XXX)
Net pre-tax cash flow from partnership	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>
Taxable income—gains and losses:			
For the forecast period	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>
For the three-year period ending December 31, 19X8	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>
From sale and dissolution	<u>\$XXX</u>	<u>\$XXX</u>	<u>\$XXX</u>

²⁷ To be consistent with the purpose of disclosing the hypothetical sale of the entity's real estate investment, the capitalization rate assumed should be consistent with the assumptions used in the forecast as well as the entity's and the industry's experience.

This information is less reliable than the information presented in the financial forecast and, accordingly, is presented for analysis purposes only. Further, there can be no assurance that events and circumstances described in this analysis will occur.

Example 2

Note B: Supplemental Information Related to Periods Beyond the Forecast Period

While management is unable to prepare a financial forecast for periods beyond 19X5, it believes that the following information is necessary for users to make a meaningful analysis of the forecasted results.

Management's forecast for the three years ending December 31, 19X5, anticipates sales of its Model 714 High Tech Laser Analyzers and related equipment in the amounts of \$13,500,000, \$14,000,000, and \$14,500,000, respectively. Such sales represent approximately 50 percent of the Company's sales for the forecast period and were the major reason for the Company's growth in 19X0 and 19X1. The Company is currently a leader in laser technology, and its Model 714 Analyzer is now widely used by the industry. However, the Company expects sales of this product to peak in 19X5 and decline in periods subsequent to the forecast period. The Company is currently developing the Model 714A High Tech Analyzer, which is an improvement on the Model 714 Analyzer, and an X series visual modulator and laser scanner.

This information is less reliable than the information presented in the financial forecast and, accordingly, is presented for analysis purposes only. Further, there can be no assurance that the events and circumstances described herein will occur.

Question

.52 A responsible party may prepare a financial forecast that requires disclosures like those illustrated in paragraphs .47 through .51 of this SOP, and he or she may request an accountant to compile or examine the forecast. What is the accountant's responsibility for such disclosures when he or she provides a compilation or examination service?

Answer

.53 In applying procedures to provide assurance that the forecast conforms to AICPA presentation guidelines in an examination, or in reading the forecast for conformity with the guidelines in a compilation, the accountant should consider whether such disclosures are required and, if so, whether they are made. The accountant is not required to design specific procedures to identify conditions and events that might occur beyond the forecast period. Rather, the accountant's consideration is based on information about management's existing plans, future events, and circumstances obtained during the course of the engagement.²⁸

.54 Disclosures of long-term results are included in the notes to the financial forecast and are, therefore, covered by the accountant's standard report. Accordingly, the extent of procedures performed depends on whether the engagement is a compilation or an examination. Compilation and examination procedures for engagements for prospective financial statements are included in chapters 12 and 15 of the Guide, respectively. When those procedures are performed, consideration should be given to whether (a) the disclo-

²⁸ The accountant is not responsible for anticipating future events, circumstances, or management plans. Further, the accountant's report does not imply assurance that all such matters that might occur beyond the forecast period have been disclosed.

ures are consistent with management's existing plans and knowledge of future events and circumstances, and (b) the disclosures are presented in conformity with the guidelines in paragraph .50 of this SOP.

.55 If, when performing a compilation engagement, the accountant concludes, on the basis of known facts, that the disclosures are obviously inappropriate, incomplete, or misleading, given their purpose, or the disclosures are not presented in conformity with the guidelines given in paragraph .50, the accountant should discuss the matter with the responsible party and propose an appropriate revision of the disclosures. If the responsible party does not agree to revise the disclosures, the accountant should follow the guidance in chapters 12 and 14 of the Guide.

.56 If, when performing an examination engagement, the accountant has reservations about the disclosures or if he or she is unable to apply procedures to such disclosures considered necessary in the circumstances, the accountant should discuss such matters with the responsible party and propose appropriate revision of the disclosures. If the responsible party will not agree to revision of the disclosures, the accountant should follow the guidance in chapter 16 of the Guide.

The Accountant's Consideration of Whether the Responsible Party Has a Reasonably Objective Basis for Presenting a Financial Forecast

Question

.57 Paragraph 10.14 of the Guide indicates that an accountant who has been engaged to compile or examine a financial forecast should consider whether the responsible party has a reasonably objective basis to present a forecast.²⁹ In considering whether the responsible party has a reasonably objective basis, the accountant would consider whether sufficiently objective assumptions can be developed for each key factor. Do the procedures in chapters 12 and 15 of the Guide, "Compilation Procedures" and "Examination Procedures," respectively, contemplate such a consideration?

Answer

.58 Yes. An accountant may become aware of information that raises questions about whether the responsible party has a reasonably objective basis for presenting a financial forecast as he or she performs the procedures required for a compilation (see paragraph 12.10 of the Guide), particularly when making inquiries about key factors (see paragraph 12.10c of the Guide), reading the forecast, and considering whether significant assumptions appear to be not obviously inappropriate (see paragraph 12.10(ii) of the Guide). In any event, paragraph 10.14 of the Guide states that whether the responsible party has a reasonably objective basis to present a forecast would be a factor in the accountant's consideration about whether the presentation would be misleading (see paragraph 12.10j of the Guide).³⁰ In an examination engagement, the

²⁹ See paragraph 7.03 of the Guide.

³⁰ The accountant's compilation procedures do not contemplate an evaluation of the support for underlying assumptions, which is required in an examination of prospective information. Because of the limited nature of the procedures, a compilation does not provide assurance that the accountant will become aware of significant matters that might be disclosed by more extensive procedures.

accountant considers whether the responsible party has a reasonably objective basis for presenting a financial forecast when he or she evaluates the support underlying the assumptions thereto. In either case, the guidance for preparers given in paragraphs .01 through .43 of this SOP may be useful to the accountant.³¹

Effective Date

.59 The presentation guidelines in this SOP are effective for prospective financial information prepared on or after August 31, 1992. The guidance on accountants' services is effective for engagements in which the date of completion of the accountants' services on prospective financial information is August 31, 1992, or later. Early application of the provisions of this statement is encouraged.

³¹ Often, an accountant considers whether a preparer has a reasonable objective basis to present a financial forecast before accepting an engagement to perform compilation or examination services. In that case, the guidance in paragraphs .01 through .43 of this SOP may be particularly useful.

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(1991)**

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The task force gratefully acknowledges the contributions made to the development of this statement of position by former task force members Richard M. Steinberg and Robert W. Berliner.

[The next page is 30,551.]

Section 11,230

Statement of Position 92-4 Auditing Insurance Entities' Loss Reserves

May, 1992

NOTE

This Statement of Position presents the recommendations of the Auditing Insurance Entities' Loss Reserves Task Force of the Insurance Companies Committee regarding the audit of the liability for loss reserves on the financial statements of property and liability insurance entities in an audit conducted in accordance with generally accepted auditing standards. It has been reviewed by the chairman of the Auditing Standards Board for consistency with existing auditing standards. AICPA members may have to justify departures from the recommendations in this Statement of Position if their work is challenged.

Introduction

.01 This statement of position (SOP) is designed to assist auditors in developing an effective audit approach when auditing loss reserves of insurance entities. It is intended to supplement the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* (audit guide). The SOP assumes the reader is familiar with the audit guide, particularly those sections in chapter 4 that describe the claims cycle.

Scope

.02 The guidance in this SOP applies to audits of property and liability insurance enterprises (stock and mutuals), reciprocal or interinsurance exchanges, pools, syndicates, captive insurance companies, and other similar organizations such as public entity risk pools. The overall concepts discussed herein are applicable to all lines of insurance; however, this study uses examples and illustrations from the more traditional lines of property and liability insurance.

.03 This SOP does not cover certain auditing issues tangentially related to loss reserves, including the evaluation of—

- Premium deficiencies.
- Transfer of risk.
- Credit risk on reinsurance contracts.
- Effects of discounting loss reserves.
- Other financial statement amounts that may be affected by loss reserves such as contingent commissions.

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Statements of Position

Effective Date

.04 This statement of position is effective for audits of financial statements for periods ending after December 15, 1992.

§11,230.04

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Chapter 1

ACCOUNTING FOR LOSS RESERVES

.05 This chapter provides background on accounting for loss reserves and describes the applicable authoritative literature in this area. The audit guide (paragraphs 4.01 through 4.04) presents the following description of generally accepted accounting principles and statutory accounting practices for insurance entities.

Accounting Practices

4.01 The specialized industry accounting principles for insurance enterprises are described in FASB Statement No. 60, FASB Statement No. 97, FASB Statement No. 113, SOP 92-5, *Accounting for Foreign Property and Liability Reinsurance*, SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises*, and SOP 97-3, *Accounting by Insurance and Other Enterprises for Insurance-Related Assessments*.

4.02 Under GAAP, liabilities for the cost of unpaid claims, including estimates of the cost of claims incurred but not reported, are accrued when insured events occur. The liability for unpaid claims should be based on the estimated ultimate cost of settling the claims (that is, the total payments expected to be made) and should include the effects of inflation and other social and economic factors. Estimated recoveries on unpaid claims, such as salvage, subrogation, and reinsurance, are deducted from the liability for unpaid claims. A liability for those adjustment expenses expected to be incurred in the settlement of unpaid claims should be accrued when the related liability for unpaid claims is accrued. Changes in estimates of the liabilities resulting from their periodic review and differences between estimates and ultimate payments are reflected in the income of the period in which the estimates are changed or the claim is settled. If the liabilities for unpaid claims and claim-adjustment expenses are discounted (that is, the liabilities are not recorded at their ultimate cost because the time value of the money is taken into consideration), the amount of the liabilities presented at present value in the financial statements and the range of interest rates used to discount those liabilities are required to be disclosed. For public companies, the SEC staff issued Staff Accounting Bulletin No. 62, *Discounting by Property/Casualty Insurance Companies*, which discusses the appropriate accounting and financial reporting when a company adopts or changes its policy with respect to discounting certain unpaid claims liabilities related to short-duration insurance contracts. The SEC issued Financial Reporting Release No. 20, *Rules and Guide for Disclosures Concerning Reserves for Unpaid Claims and Claim Adjustment Expenses of Property-Casualty Underwriters*, which requires additional disclosures concerning the underwriting and claims reserving experience of property-casualty underwriters. The SEC staff also issued Staff Accounting Bulletin No. 87, *Contingency Disclosures on Property/Casualty Insurance Reserves for Unpaid Claim Costs*, which provides guidance concerning those uncertainties surrounding property and casualty loss reserves that may require FASB Statement No. 5 contingency disclosures and Staff Accounting Bulletin No. 92, *Accounting and Disclosures Relating to Loss Contingencies*, which provides the SEC staff's interpretation of current accounting literature relating to the following:

- Offsetting of probable recoveries against probable contingent liabilities
- Recognition of liabilities for costs apportioned to other potential responsible parties

- Uncertainties in estimation of the extent of environmental or product liability
- The appropriate discount rate for environmental or product liability, if discounting is appropriate
- Accounting for exit costs
- Financial statement disclosures and disclosure of certain information outside the basic financial statements

Statutory Accounting Practices

4.03 Statutory accounting practices (SAP), which vary by state, are similar to GAAP for transactions in the claims cycle—estimated liabilities for unpaid claims, including IBNR [incurred but not reported] and claim-adjustment expenses, are accrued when the insured events occur; however, there are certain differences. Under SAP, reinsurance recoverable on unpaid losses is deducted from the liability for unpaid claims. For certain lines of insurance, such as auto liability, general liability, medical malpractice, and workers' compensation, a minimum statutory reserve may be required. The formula for determining this reserve is described in the footnotes to Schedule P in the NAIC Annual Statement. If it is determined that an additional statutory reserve is needed, this amount is reported as a separate liability and a reduction from surplus.

4.04 Discounting of loss reserves varies by state. SAP generally permits discounting settled lifetime workers' compensation claims and accident and health long-term disability claims at discount rates of 4 percent or less. In some states, medical malpractice liability claims may also be discounted. For statutory reporting purposes, reinsurance recoverable balances are segregated between those recoverable from companies authorized by the state to transact reinsurance and those recoverable from other companies, called unauthorized reinsurers. Insurance companies are required to provide a reserve by a charge to surplus for reinsurance that is recoverable from unauthorized companies. The reserve is provided to the extent that funds held or retained for account of such companies are exceeded or not secured by trust accounts or by letters of credit.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Chapter 2

THE LOSS RESERVING PROCESS

Types of Business and Their Effect on the Estimation Process

.06 The reporting and payment characteristics of a company's losses will differ depending on the types of policies written. Insurance policies may be categorized in several different ways:

- By policy duration (short duration or long duration)
- By type of coverage provided (occurrence basis or claims-made basis)
- By kind of insurance underwritten (for example, property, liability, workers' compensation, and reinsurance)¹

Policy Duration

.07 Insurance policies are considered to be either short-duration or long-duration. Policies are considered short-duration when the contract provides for insurance coverage for a fixed period of short duration and enables the insurer to cancel the contract or adjust the provisions of the contract at the end of the contract period. Policies are considered long-duration when the contract provides for insurance coverage for an extended period and is not generally subject to unilateral changes in its provisions. Because most policies written by property and liability insurance companies are short-duration policies, only short-duration contracts are considered in this SOP.

Type of Coverage

.08 Insurance policies may be issued on either an occurrence basis or a claims-made basis. Occurrence-basis policies provide coverage for insured events occurring during the contract period, regardless of the length of time that passes before the insurance company is notified of the claim. Under occurrence-basis policies, claims may be filed months or years after the policy contract has expired, making it difficult to estimate the eventual number of claims that will be reported. Theoretically, a pure claims-made policy only covers claims reported to the insurer during the contract period; however, in practice, claims-made policies generally cover claims reported to either the insurer or the insured during the contract period. As a result, claims may be reported to the insurer after the contract expires. Even if claims have been reported to the insurer during the contract period, it may take several months for the insurer to investigate and establish a case reserve for reported claims. In practice, most claims-made insurance policies contain "extended reporting" clauses or endorsements that provide for coverage, in specified circumstances, of claims occurring during the contract period but reported after the expiration of the policy. In many states, a claims-made insurance policy is required to (a) contain an extended-reporting clause, (b) provide for the purchase, at the policyholder's option, of "tail coverage," that is, coverage for events occurring

¹ The terms *line of business* and *type of risk* are used interchangeably to mean kind of insurance underwritten.

during the policy term but reported after the initial policy expires, or (c) provide for automatic tail coverage upon the death, disability, or retirement of the insured. Thus, in practice, claims-made policies can resemble occurrence-basis policies. If a claims-made insurance policy provides for coverage of claims incurred during the policy period but reported to the insurer after the end of the policy period, loss reserve requirements for such claims should be considered.

Kind of Insurance Underwritten, Line of Business, or Type of Risk

.09 The kind of insurance underwritten by property and liability insurance companies may be broadly categorized into five classes of coverage: property, liability, workers' compensation, surety, and fidelity. Additionally, policies may be written as primary coverage or reinsurance assumed. Paragraphs 4.09 through 4.13 in chapter 4 of the audit guide describe the loss characteristics of different types of coverage.

.10 Some lines of insurance are commonly referred to as "long-tail" lines because of the extended time required before claims are ultimately settled. Examples of long-tail lines are automobile bodily injury liability, workers' compensation, professional liability, and other lines such as products and umbrella. Lines of insurance in which claims are settled relatively quickly are called "short-tail" lines. It is generally more difficult to estimate loss reserves for long-tail lines because of the long period that elapses between the occurrence of a claim and its final disposition, and the difficulty of estimating the settlement value of the claim.

Components of Loss Reserves

.11 Loss reserves are an insurer's estimate of its liability for the unpaid costs of insured events that have occurred. An insurance company's loss reserves consist of one or more of the components described below. All of these components should be considered in the loss-reserving process but may not have to be separately estimated.

Case-basis reserves—The sum of the values assigned by claims adjusters to specific known claims that were recorded by the insurance company but not yet paid at the financial statement date. Chapter 4 of the audit guide describes the most common methods used by companies to establish case-basis reserves.

Case-development reserves—The difference between the case-basis reserves and the estimated ultimate cost of such recorded claims. This component recognizes that case-basis reserves, which are estimates based on incomplete or preliminary data, will probably differ from ultimate settlement amounts. Accordingly, a summation of case-basis reserve estimates may not produce the most reasonable estimate of their ultimate cost.

Incurred but not reported (IBNR)—The estimated cost to settle claims arising from insured events that occurred but were not reported to the insurance company as of the financial statement date. This component includes reserves for claims "in transit," that is, claims reported to the company but not yet recorded and included in the case-basis reserve.

Reopened-claims reserve—The cost of future payments on claims closed as of the financial statement date that may be reopened due to circumstances unforeseen at the time the claims were closed.

Sometimes, case-development reserves, IBNR, and the reopened-claims reserve are calculated as a single reserve and broadly referred to as IBNR. In addition to the basic components of loss reserves, a company will also need to estimate the effect of the following components:

Reserves for loss adjustment expenses (LAE). These include the following:

- *Allocated loss adjustment expenses (ALAE)*—Expenses incurred in the claim settlement process that can be directly associated with specific claims, such as legal fees or outside adjuster fees. If this reserve is estimated on a case basis, a reserve for ALAE development, IBNR, and reopened claims should be provided.
- *Unallocated loss adjustment expenses (ULAE)*—Expenses incurred in the claim settlement process that cannot be directly associated with specific claims, such as costs incurred by the insurer's claims operations to record, process, and adjust claims.

Reduction for salvage—The estimated amount recoverable by the insurer from the disposition of damaged or recovered property. Potential salvage on paid and unpaid losses should be considered in this estimate.

Reduction for subrogation—The estimated amount recoverable from third parties from whom the insured may have the right to recover damages. The insured, having collected benefits from the insurer; is required to subrogate such rights to the insurer.

Drafts outstanding—Some insurance companies may elect to pay claims by draft rather than by check and may not record the drafts as cash disbursed until the drafts are presented to the insurer by the bank. A liability for drafts outstanding is required only if cash disbursements and claim statistical information are not recorded concurrently, thereby creating a timing difference. Because the claim statistical information is updated to reflect the payment, no loss reserve is recorded for the claim; however, because the draft has not been presented, a drafts outstanding liability is required.

Reserves for assessments based on paid losses—The estimated amount of future assessments relating to payments on losses incurred prior to the financial statement date. An example is assessments by state workers' compensation second-injury funds. Such assessments are recorded as losses and should be considered in the loss reserving process.

Reinsurance receivables—Amounts that will be recovered from reinsurers for losses and LAE accrued, including IBNR losses accrued. Amounts receivable from reinsurers on paid and unpaid losses are generally classified as assets.

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.12 Many insurance companies do not separately value each of the reserve components listed above. Frequently, an insurance company's reserve for case development is combined with its reserve for IBNR claims. Reinsurance and other recoveries may be netted against claim payments in the insurance company's records. In those situations, all reserve estimates are also net of recoveries; separate analysis is then performed to determine the appropriate amount to record as the reinsurance receivable asset. ALAE may be combined with loss payments and included in these components. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Estimating Methods

.13 Various analytical techniques exist to assist management, consulting actuaries, and independent auditors in estimating and evaluating the reasonableness of loss reserves. These techniques generally consist of statistical analyses of historical experience and are commonly referred to as loss reserve projections.

.14 Loss reserve projections are used to develop loss reserve estimates. Understanding and assessing the variability of these estimates and the reliability of historical experience as an indicator of future loss payments require a careful analysis of the historical loss data and the use of projection methods that are sensitive to the particular circumstances.

.15 The data used for projections is generally grouped by line of business and may be further classified by attributes such as geographic location, underwriting class, or type of coverage to improve the homogeneity of the data within each group. The data is then arranged chronologically. The following are dates that are key to classifying the chronology of the data.

Policy date—The date on which the contract becomes effective (also referred to as the underwriting date).

Accident date—The date on which the accident (or loss) occurs.

Report date—The date on which the company first receives notice of the claim.

Record date—The date on which the company records the claim in its statistical system.

Closing date—The date on which the claim is closed.

.16 After the data has been grouped by line of business and by chronology, it may then be arrayed to facilitate the analysis of the data, highlight trends, and permit ready extrapolation of the data. The following are examples of types of data that are commonly arrayed and analyzed:

- Losses paid
- Losses incurred
- Case reserves outstanding
- Claim units reported
- Claim units paid
- Claim units closed
- Claim units outstanding
- ALAE paid
- ALAE outstanding
- Salvage and subrogation recovered
- Reinsurance recovered
- Reinsurance receivable
- Premiums earned
- Premiums in force
- Exposures earned
- Policies in force

[Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.17 The data may be cumulative or incremental, gross or net of reinsurance, gross or net of salvage and subrogation, or combined with allocated loss adjustment data. The data may be stratified by size of loss or other criteria. Because claim data and characteristics such as dates, type of loss, and claim counts significantly affect reserve estimation, controls should be established over the recording, classification, and accumulation of historical data used in the determination of loss reserves. Exhibit B-2 in appendix B of the audit guide presents examples of such control activities. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.18 Loss reserve projections can be performed using a variety of mathematical approaches ranging from simple arithmetic projections using loss development factors to complex statistical models. Projection methods basically fall into three categories:

- Extrapolation of historical loss dollars
- Projection of separate frequency and severity data (the number of claims that will be paid or closed and the average costs of these claims)
- Use of expected loss ratios

.19 Within each of these methods, there are a variety of techniques and loss data that may be used; there are also methods that combine features of these basic methods. No single projection method is inherently better than any other in all circumstances.

.20 Following is a brief summary of some commonly used projection methods.

<u>Method</u>	<u>Basis</u>
Loss Extrapolation	
Paid loss	Uses only paid losses. Outstanding case reserves are not considered.
Incurred loss	Uses paid losses plus reserves on outstanding claims.
Average Severities	Uses various claim count and average cost per claim data on either a paid or incurred basis.
Loss Ratio	Uses various forms of expected losses in relation to premiums earned.

.21 The decision to use a particular projection method and the results obtained from that method should be evaluated by considering the inherent assumptions underlying the method and the appropriateness of these assumptions to the circumstances. Stability and consistency of data are extremely important. Changes in variables, such as rates of claim payments, claim department practices, case-basis reserving adequacy, claim reporting rates, mix of business, reinsurance retention levels, and the legal environment, may have a significant effect on the projection and may produce distortions or conflicting results. Reference should be made to the section in this chapter titled "Changes in the Environment" for a discussion of how changes in variables may affect the loss-reserving process. The results of any projection should be reviewed for reasonableness by analyzing the resultant loss ratios and losses per measure of exposure.

Illustrative Projection Data

.22 The following tables are simple illustrations of the use of the loss extrapolation method to estimate ultimate losses, as well as the effects of considering the results of more than one projection. In these illustrations, the result of extrapolating incurred-loss data is compared with the result of extrapolating paid-loss data. These tables are presented solely for the purpose of illustrating the mathematical mechanics of the two projections. They do not illustrate the required analysis of the data, and consideration of internal and external environmental variables that may affect the claim payment and loss reserving process.

.23 Table 1 presents an illustration of historical incurred-loss data. It reflects, as an example, that the sum of paid losses and case reserves outstanding at the end of 19X0 was \$2,054; that sum increased to \$2,717 in the next year and increased to \$3,270 five years later.

.24 This incurred-loss data is first used to calculate historical period-to-period incurred-loss development factors. These factors are used to compare the amount of incurred losses at successive development stages, and are illustrated in table 2, part 1.

.25 The calculation of average historical period-to-period incurred-loss development factors may be based on the use of simple averages of various period-to-period factors or may be based on more complex weighting or trending techniques. These techniques can significantly affect the reserving process and require judgment, understanding, and experience. In this example, a simple average of the latest three period-to-period factors has been calculated and is presented in table 2, part 2.

Table 1

Case-Basis Incurred-Loss Data as of 12/31/X9

Accident Year	Development Period (in months)									
	12	24	36	48	60	72	84	96	108	120
19X0	\$2,054	\$2,717	\$2,979	\$3,095	\$3,199	\$3,348	\$3,270	\$3,286	\$3,299	\$3,301
19X1	2,213	2,980	3,269	3,461	3,551	3,592	3,631	3,643	3,651	
19X2	2,341	3,125	3,513	3,695	3,798	3,849	3,872	3,876		
19X3	2,492	3,502	3,928	4,177	4,313	4,369	4,392			
19X4	2,964	4,246	4,859	5,179	5,315	5,376				
19X5	3,394	4,929	5,605	5,957	6,131					
19X6	3,715	5,433	6,162	6,571						
19X7	4,157	5,912	6,771							
19X8	4,573	6,382								
19X9	4,785									

.26 Once historical period-to-period incurred-loss development factors are calculated, future period-to-period incurred-loss development factors must be selected. The future period-to-period factors must reflect anticipated differences between historical and future conditions that affect loss development, such as changes in the underlying business, different inflation rates, or case-basis reserving practices. In the example, no differences are anticipated and the average historical factors have been chosen as the selected factors as shown in table 2, part 2. The selected future period-to-period factors are then used to produce ultimate incurred development factors. The ultimate factors are presented in table 2, part 3.

Table 2

Period-to-Period Incurred-Loss Development Factors as of 12/31/X9

Accident Year	Development Period (in months)									Est. Tail*
	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	
Part 1: Period-to-Period Historical Loss Development Factors										
19X0	1.323 [†]	1.096	1.039	1.034	1.047	0.977	1.005	1.004	1.001	
19X1	1.347	1.097	1.059	1.026	1.012	1.011	1.003	1.002		
19X2	1.335	1.124	1.052	1.028	1.013	1.006	1.001			
19X3	1.405	1.122	1.063	1.033	1.013	1.005				
19X4	1.433	1.144	1.066	1.026	1.011					
19X5	1.452	1.137	1.063	1.029						
19X6	1.462	1.134	1.066							
19X7	1.422	1.145								
19X8	1.396									
Part 2: Period-to-Period Average Development Factors										
<i>Simple Average of Latest Three</i>										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
<i>Selected Factors</i>										
	1.427	1.139	1.065	1.029	1.012	1.007	1.003	1.003	1.001	1.000
Part 3: Ultimate Development Factors Selected for the Projection										
	1.828 [‡]	1.281	1.125	1.056	1.026	1.014	1.007	1.004	1.001	1.000

* Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.000 in this illustration).

[†] The 24-month developed losses are divided by the 12-month developed losses from table 1 ($\$2,717/\$2,054 = 1.323$).

[‡] The product of the remaining factors ($1.427 \times 1.139 \times 1.065 \times 1.029 \times 1.012 \times 1.007 \times 1.003 \times 1.003 \times 1.001 \times 1.000 = 1.828$) or the product of the 12-24 selected factor times the 24-36 ultimate factor ($1.427 \times 1.281 = 1.828$).

.27 The loss reserve analysis has now reached the point where an initial projection of ultimate losses, as well as an indicated provision for unreported losses for each accident year, can be made by using the historical incurred-loss data and the ultimate incurred-loss development factors. This initial projection of ultimate losses is presented in table 3.

.28 Tables 4 and 5 present paid-loss data for the same company whose incurred-loss data was presented in table 1. The array of paid-loss period-to-period development factors presented in table 5 is derived from table 4 using the same calculation methods used for incurred losses in table 2. The importance of the use of a tail factor in this calculation is apparent from the period-to-period historical loss development factors calculated in table 5. The tail factor represents an estimate of the development of losses beyond the period covered by the data array. In this instance, a tail factor of 1.01 was selected to project an additional 1 percent of losses to be paid from the tenth development year to ultimate. Selection of a tail factor requires careful judgment based on consideration of industry experience for the line of business, actuarial studies, case reserves, and any other relevant information.

.29 The initial projection of ultimate losses, using the historical paid losses and the paid-loss ultimate development factors, is presented in table 6.

.30 Table 7 compares the results of extrapolating paid-loss data (table 6) with the results of extrapolating incurred-loss data (table 3).

.31 Although all accident periods should be analyzed and trends evaluated, it is clear that additional analysis of accident year 19X9 losses is required. The difference between the results obtained from the two different projections is significant. Initial inspection will trace the source of the difference to the high level of losses paid in 19X9 for accident year 19X9 relative to case-basis incurred losses for the same period. The loss reserving analysis must focus on whether the increase in payments represents an acceleration of payment activity or an increase in the overall level of losses incurred in 19X9. The benefit of using more than one projection is that it allows for this kind of analysis and comparison in the evaluation of loss reserves.

Table 3

Incurred-Loss Projection as of 12/31/X9

Accident Year	Case-Basis Incurred Losses as of 19X9*	Ultimate Incurred-Loss Development Factors†	Projected Ultimate Losses (2) × (3)	Projected Unreported Losses (4) - (2)
(1)	(2)	(3)	(4)	(5)
19X0	\$ 3,301	1.000	\$ 3,301	\$ 0
19X1	3,651	1.001	3,655	4
19X2	3,876	1.004	3,892	16
19X3	4,392	1.007	4,423	31
19X4	5,376	1.014	5,451	75
19X5	6,131	1.026	6,290	159
19X6	6,571	1.056	6,939	368
19X7	6,771	1.125	7,617	846
19X8	6,382	1.281	8,175	1,793
19X9	4,785	1.828	8,747	3,962
Total	<u>\$51,236</u>		<u>\$58,490</u>	<u>\$7,254</u>

* From table 1

† From table 2, part 3

Table 4

Paid-Loss Data as of 12/31/X9

Accident Year	Development Period (in months)									
	12	24	36	48	60	72	84	96	108	120
19X0	\$ 896	\$1,716	\$2,291	\$2,696	\$3,041	\$3,096	\$3,185	\$3,235	\$3,262	\$3,276
19X1	872	1,840	2,503	2,973	3,261	3,429	3,538	3,589	3,624	
19X2	968	1,975	2,683	3,185	3,494	3,670	3,763	3,819		
19X3	968	2,130	2,968	3,571	3,942	4,147	4,274			
19X4	1,201	2,580	3,673	4,421	4,860	5,114				
19X5	1,348	2,996	4,207	5,115	5,632					
19X6	1,340	3,146	4,520	5,496						
19X7	1,384	3,428	4,960							
19X8	1,568	3,696								
19X9	2,243									

Table 5

Period-to-Period Paid-Loss Development Factors as of 12/31/X9

Accident Year	Development Period (in months)									Est.* Tail
	12-24	24-36	36-48	48-60	60-72	72-84	84-96	96-108	108-120	
Part 1: Period-to-Period Historical Loss Development Factors[†]										
19X0	1.915	1.335	1.177	1.128	1.018	1.029	1.016	1.008	1.004	
19X1	2.110	1.360	1.188	1.097	1.052	1.032	1.014	1.010		
19X2	2.040	1.358	1.187	1.097	1.050	1.025	1.015			
19X3	2.200	1.393	1.203	1.104	1.052	1.031				
19X4	2.148	1.424	1.204	1.099	1.052					
19X5	2.223	1.404	1.216	1.101						
19X6	2.348	1.437	1.216							
19X7	2.477	1.447								
19X8	2.357									
Part 2: Period-to-Period Average Development Factors										
<i>Simple Average of Latest Three</i>										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
<i>Selected Factors</i>										
	2.394	1.429	1.212	1.101	1.051	1.029	1.015	1.009	1.004	1.010
Part 3: Ultimate Development Factors Selected for the Projection[†]										
	5.127	2.142	1.499	1.237	1.123	1.069	1.039	1.023	1.014	1.010

* Applies when the development period is determined to be longer than the period covered by the model (assumed to be 1.010 in this illustration).

[†] Computations are the same as those explained in table 2.

Table 6

Paid-Loss Projection as of 12/31/X9

<i>Accident Year</i>	<i>Paid Losses as of 19X9</i>	<i>Ultimate Loss Development Factors</i>	<i>Projected Ultimate Losses (2) × (3)</i>	<i>Projected Unreported Losses *</i>
(1)	(2)	(3)	(4)	(5)
19X0	\$ 3,276	1.010	\$ 3,309	\$ 8
19X1	3,624	1.014	3,675	24
19X2	3,819	1.023	3,907	31
19X3	4,274	1.039	4,439	47
19X4	5,114	1.069	5,465	89
19X5	5,632	1.123	6,325	194
19X6	5,496	1.237	6,796	225
19X7	4,960	1.499	7,434	663
19X8	3,696	2.142	7,916	1,534
19X9	2,243	5.127	11,500	6,715
Total	<u>\$42,134</u>		<u>\$60,766</u>	<u>\$9,530</u>

* Represents the projected ultimate losses from table 6, column 4, less the recorded case-basis incurred losses from table 3, column 2.

Table 7

Alternative Projections of Ultimate Losses and Unreported Losses as of 12/31/X9

<i>Accident Year</i>	<i>Ultimate Losses</i>		<i>Unreported Losses</i>	
	<i>Incurred</i>	<i>Paid</i>	<i>Incurred</i>	<i>Paid</i>
19X0	\$ 3,301	\$ 3,309	\$ 0	\$ 8
19X1	3,655	3,675	4	24
19X2	3,892	3,907	16	31
19X3	4,423	4,439	31	47
19X4	5,451	5,465	75	89
19X5	6,290	6,325	159	194
19X6	6,939	6,796	368	225
19X7	7,617	7,434	846	663
19X8	8,175	7,916	1,793	1,534
19X9	8,747	11,500	3,962	6,715
Total	<u>\$58,490</u>	<u>\$60,766</u>	<u>\$7,254</u>	<u>\$9,530</u>

Loss Adjustment Expense Reserves

.32 Loss adjustment expense reserves are the costs that will be required to settle claims that have been incurred as of the valuation date. As explained in paragraph .11, loss adjustment expenses (LAE) can be classified into two broad categories: allocated loss adjustment expenses (ALAE) and unallocated loss adjustment expenses (ULAE).

ALAE Reserve Calculation Approaches

.33 ALAE is generally analyzed by line of business; however, it is also important to monitor the composition of the paid ALAE by cost component. A shift in the composition of the costs in relation to the total might affect the statistical data used in the related loss projections. This shift would need to be considered in future loss reserve projections.

.34 Many companies calculate ALAE reserves based on the relationship of ALAE to losses. Underlying this approach is a basic assumption that ALAE will increase or decrease in proportion to losses. The setting of reserves for ALAE based on the relationship of paid ALAE to paid losses is referred to as the "paid-to-paid ratio" approach. Separate ratios are normally developed for each accident year. Inflation in ALAE is not typically evaluated separately; rather, it is estimated to occur at the same rate as the rate of inflation in the losses. The validity of this assumption can be tested by reviewing historical relationships between ALAE and losses over time. The effects of a pattern of increasing or decreasing ratio of ALAE to losses should be considered in establishing ALAE reserves. An understanding of the claim department's operations and philosophy over time is essential to a proper interpretation of the data.

.35 Other approaches to ALAE reserve calculation and analysis include (a) analyzing ALAE entirely apart from the related loss costs using methods that compare the development of ALAE payments at various stages and (b) using combined loss and ALAE data in situations where it appears likely that this would produce more accurate estimates (e.g., when the company has changed its claim defense posture so that defense costs increase and loss costs decrease). In this latter approach, statistical tests and projections are based on the combined data for losses and ALAE.

.36 Some companies establish case-basis reserves for certain types of ALAE or increase case-basis loss reserves by a stated percentage to provide for ALAE. In either case, additional ALAE reserves should be provided for the development of case-basis reserves and IBNR.

ULAE Reserve Calculation Approaches

.37 ULAE reserves are often provided for by using the calendar year paid-to-paid method rather than the accident year paid-to-paid method used for ALAE reserves. Although the paid-to-paid ratios establish the relationship of the ULAE payments to the loss payments, the timing of the ULAE payments is also critical to estimation of the ULAE reserves. For example, some companies assume that a portion of ULAE costs is incurred when a claim is placed on the books and the remaining portion is incurred when the claim is settled. For reported claims, the cost of placing the claim on the books has been incurred, so it is only necessary to provide a reserve for the remaining portion at settlement. For IBNR claims, it is necessary to provide for all of the ULAE. Some companies perform internal studies to establish the methods and ratios to be used in their calculations.

.38 The ULAE reserves should provide for inflation. The assumption that ULAE will inflate at a rate equal to the rate at which losses inflate should be periodically reviewed. The rate should also be adjusted for expected technological or operational changes that might cause economies or inefficiencies in the claim settlement process.

.39 If paid-to-paid ULAE ratios will be calculated for each line of business, a reasonable basis for allocating paid ULAE by line of business should be established.

Changes in the Environment

.40 Loss reserve projections are used to estimate loss reporting patterns, loss payment patterns, and ultimate claim costs. An inherent assumption in such projections is that historical loss patterns can be used to predict future patterns with reasonable accuracy. Because many variables can affect past and future loss patterns, the effect of changes in such variables on the results of loss projections should be carefully considered.

.41 Identification of changes in variables and consideration of their effect on loss reserve projections are critical steps in the loss reserving process. The evaluation of these factors requires the involvement of a loss reserve specialist as well as input from various operating departments within the company such as the marketing, underwriting, claims, actuarial, reinsurance, and legal departments. Management's use of a specialist in determining loss reserves is discussed in paragraphs .44 through .47 of this SOP.

.42 Variables to be considered in evaluating the results of loss reserve projections include those variables affecting inherent and control risk described in the Appendix [paragraph .107] of this SOP. If changes in variables have occurred, mechanical application of loss projection methods may result in unreasonable estimates of ultimate claim costs. Changes in variables can be considered in the loss reserving process in a variety of ways, including—

- *Selection of loss projection method(s).* Loss projection methods vary in their sensitivity to changes in the underlying variables and to the length of the claim emergence pattern. When selecting a loss projection method, consideration should be given to how a change in the underlying data will affect that method. For example, if management has adopted a policy to defer or accelerate the settlement of claims, a paid-loss extrapolation method will probably produce unreliable results. In that case, an incurred-loss extrapolation or other methods may produce better estimates of ultimate losses.
- *Adjustment of underlying historical loss data.* In certain cases, the effect of changed variables can be isolated and appropriately reflected in the historical loss data used in the loss projection. For example, if policy limits are relatively consistent for all policies in a block of business, and if these limits have recently been reduced by a constant amount, historical loss data can be adjusted to exclude amounts in excess of the revised policy limits.
- *Further segregation of historical loss data.* Certain changes in variables can be addressed by further differentiating and segregating historical loss data. For example, if a company begins to issue claims-made policies for a line of business for which it traditionally issued occurrence-basis policies, segregation of data between the two types of

policies should minimize the effect of the different reporting patterns. Such segregation should produce more accurate loss reserve projections for the occurrence-basis policies. (However, loss development data relating to the claims-made policies will be limited in the initial years.)

- *Separate calculation of the effect of variables.* The effect of certain changes in variables can be isolated and separately computed as an adjustment to the results of other loss projection methods. For example, if claim cost severity has increased (an increase in auto repair costs) or is expected to increase beyond historic trends, an additional reserve can be separately computed to reflect the effect of such actual or anticipated increases.
- *Qualitative assessments.* In many instances, the magnitude or effect of a change in a variable will be uncertain. The establishment of loss reserves in such situations requires considerable judgment and knowledge of the company's business. Following is an example of an environmental variable that may have uncertain effects on loss reserve estimates.

Superfund legislation enacted by Congress seeks recovery from anyone who ever owned or operated a particular contaminated site or from anyone who ever generated or transported hazardous materials to a site. These parties are commonly referred to as potentially responsible parties, or PRPs. Potentially, the liability can extend to subsequent owners or to the parent company of a PRP.

Estimates of the cost of cleaning up hazardous waste sites currently on the so-called Superfund list are in the hundreds of billions of dollars. Third-party damages, legal defense costs, and cleanup expenses for non-Superfund sites will add significantly to this figure. It is conceivable, but by no means certain, that some portion of these costs will ultimately be borne by the insurance industry under pre-1986 liability coverages because insurance companies that wrote general liability or commercial multiperil policies prior to 1986 used policy forms that did not contain the "absolute" pollution exclusion currently in standard use within the industry. Some insureds are arguing that coverage should be afforded under these contracts for their potential liability for the cleanup of inactive hazardous waste sites or other similar environmental liabilities. Most insurers are vigorously resisting such arguments with mixed success in the courts. Although some major U.S. corporations and specialized industries have begun to litigate pollution liability coverage issues, these cases may represent only the tip of the iceberg. Potential for additional litigation exists in the form of non-Superfund claims that will be reported to insurers in the future.

Although the largest environmental liabilities are likely to arise from chemical producers, petroleum processors, and other "heavy" industries, any company writing liability coverage has some environmental liability exposure for service stations, dry cleaners, hardware stores, paint stores, gardening supply stores, small metal plating operations, and the like. Even homeowners' policies are potentially exposed to the cleanup costs for leaks from underground heating oil storage tanks.

The development of environmental and similar claims may not follow the usual development pattern of general liability claims, with which they are usually grouped. When the activity of these claims is sufficient to distort the recorded

development of the company, the distorting activity should be isolated from the development history so that an accurate projection of the remaining claims can be made. Management's process of assessing its environmental and similar exposure should include procedures to—

- Insure that all data elements are recorded on each incoming claim or precautionary notice.
- Assess the company's exposure to these types of liability claims by considering such factors as the types of risks historically written, layers of coverage provided, the policy language employed, and recent decisions rendered by courts.
- Determine whether any portion of potential liability costs is probable and reasonably estimable.

.43 Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, provide guidance for the accounting and disclosure of loss contingencies.

Use of Specialists by Management in Determining Loss Reserves

.44 Management is responsible for making the accounting estimates included in the financial statements. As explained in the previous sections of this chapter, the process of estimating loss reserves is complex and involves many subjective judgments. Accordingly, the determination of loss reserves should involve an individual with a sufficient level of competence and experience in loss reserving, including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of appropriate methods available for calculating loss reserve estimates. These individuals are referred to as "loss reserve specialists" in this SOP. The specialist's level of competence and experience should be commensurate with the complexity of the company's business, which is affected by such factors as the kind(s) of insurance underwritten and the environmental and risk considerations listed in the Appendix [paragraph .107] of this SOP. Criteria that may be considered in determining whether an individual qualifies as a loss reserve specialist include the aforementioned as well as the following:

- Knowledge of various projection techniques, including their strengths and weaknesses and applicability to various lines of insurance
- Knowledge of changes in the environment in which the company operates, including regulatory developments, social and legal trends, court decisions, and other factors described in more detail in the Appendix and the effect that these factors will have on the emergence and ultimate cost of these claims

.45 The Casualty Actuarial Society (CAS) offers a course of study and examinations that are designed to train individuals to be, among other things, loss reserve specialists. In addition, the American Academy of Actuaries establishes qualification standards for its members who practice in this area. Although many casualty actuaries may therefore be qualified to be loss reserve specialists, other individuals, through their experience and training, may also be qualified. Training and experience should provide individuals with knowl-

edge about different policy forms and coverages, current developments in insurance, and environmental factors that might affect the loss reserving process. Training and experience should also provide individuals with knowledge that will enable them to apply appropriate methods of estimating loss reserves. The extent of this knowledge and ability should be commensurate with the complexity and kinds of business written.

.46 Many insurance companies use loss reserve specialists who are employees or officers of the company. In addition, many companies engage consulting casualty actuaries to either assist in the determination of the loss reserve estimate or to perform a separate review of the company's loss reserve estimate. The scope of work to be performed by the consulting actuary is a matter of judgment by company management. Usually, the consulting actuary will issue a report summarizing the nature of the work performed and the results. Since 1990, the Annual Statement has required a Statement of Actuarial Opinion relating to loss and loss adjustment expense reserves.

.47 Because the process of estimating loss reserves is complex and involves many subjective judgments, the absence of involvement by a loss reserve specialist in the determination of management's estimate may constitute a reportable condition and possibly a material weakness in the entity's internal control structure. Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, describes the auditor's responsibility to communicate reportable conditions to the audit committee. A discussion of the auditor's use of loss reserve specialists is included in chapter 4.

Chapter 3

AUDIT PLANNING

Audit Objectives

.48 SAS No. 57, *Auditing Accounting Estimates*, states that the auditor's objective when evaluating accounting estimates is to obtain sufficient competent evidential matter to provide reasonable assurance that—

- a. All accounting estimates that could be material to the financial statements have been developed.
- b. Those accounting estimates are reasonable in the circumstances.
- c. The accounting estimates are presented in conformity with applicable accounting principles and are properly disclosed.

.49 When auditing loss reserves, the auditor is primarily concerned with obtaining sufficient competent evidential matter to support the assertions inherent in a company's financial statements. SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, describes the relationship between assertions embodied in the financial statements, audit objectives, and substantive audit procedures. The financial statement assertions related to loss reserves are set forth below. This listing supplements the illustrations of financial statement assertions for the claims cycle presented in exhibit B-2 in appendix B of the audit guide. [Revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Financial Statement Assertions

Existence, Rights,
Obligations

Completeness and
Valuation

Audit Objectives

- Claims represent valid obligations of the insurance company. The policy is in force when the loss is incurred and covers the related risk event. Claimants and others receiving payment are bona fide and entitled to payments within applicable policy provisions.
- Guidelines for adjusting claims and authorizing payment are established and being followed.
- Loss reserves are established for all losses resulting from insured events (reported and unreported) that occurred prior to the balance sheet date.
- Appropriate reserving methods are accurately applied and result in loss reserve estimates that represent the ultimate cost of settling all probable losses. Appropriate reductions in reserves have been taken for reinsurance ceded and salvage and subrogation recoverable.

*Financial Statement
Assertions*

Audit Objectives

Presentation and
Disclosure

- All relevant claims data, including payment and recovery data, are appropriately recorded in the underlying financial and statistical records.
- All loss reserves are appropriately recorded on the balance sheet and the income statement reflects the changes therein.
- Loss reserves are properly accumulated in the underlying financial records.
- Claims transactions are properly accumulated in the underlying financial and statistical records.
- Payments and recoveries are recorded in the proper period; a proper cutoff is established.
- Loss reserves and related components have been properly summarized, classified, and described and all matters necessary to a proper understanding of these items have been disclosed.

Audit Planning

.50 In planning the audit, the auditor should obtain a thorough understanding of the company's overall operations and its claim reserving and payment practices. In addition, the auditor should obtain or update his or her knowledge of the entity's business and the various economic, financial, and organizational conditions that create risks for companies in the insurance industry.

.51 The auditor performing or supervising the audit of loss reserves should have knowledge about loss reserving including knowledge about the kind(s) of insurance for which a reserve is being established and an understanding of the appropriate methods available for calculating loss reserves. Knowledge about loss reserving is ordinarily obtained through experience, training courses, and by consulting sources such as industry publications, textbooks, periodicals, and individuals knowledgeable about loss reserving. As stated in paragraph .98 of this SOP, if the auditor is not a loss reserve specialist, he or she should use the work of an outside loss reserve specialist in the audit. The auditor should obtain a level of knowledge about loss reserving that would enable him or her to understand the methods or assumptions used by the specialist.

.52 Ordinarily, audit procedures performed to obtain sufficient evidence to support assertions about loss reserves are time consuming and may be performed most efficiently when initiated early in the fieldwork.

.53 The auditor should determine that all loss reserve components, all lines of business, and all accident years that could be material to the financial

statements have been considered in developing the overall reserve estimate, The components of loss reserves are described in chapter 2 of this SOP.

.54 The estimate of loss reserves will frequently affect other accounting estimates contained in the financial statements. While these other accounting estimates are not the subject of this SOP, the auditor should also evaluate accounting estimates for such items as contingent commissions, retrospective premium adjustments, policyholder dividends, recoverability of deferred acquisition costs, premium deficiencies, state assessments based on losses paid, minimum statutory reserves, and the liability or allowance for unauthorized or uncollectible reinsurance.

Audit Risk and Materiality

.55 Audit risk and materiality are the key criteria in determining the nature, timing, and extent of audit procedures to be performed and in evaluating whether the financial statements taken as a whole are presented fairly. Considerations of audit risk and materiality should be addressed in the planning stage of an audit and should be used to develop and support an audit approach. For most insurance companies, the largest liability on the balance sheet is loss reserves, and the largest expense on the income statement is incurred losses; therefore, both are material to the financial statements. In addition, loss reserve estimates are based on subjective judgments and, therefore, involve a high level of inherent risk. For these reasons, loss reserves typically are the area with the highest audit risk in a property and liability insurance entity. Reference should be made to the Appendix [paragraph .107] of this SOP for examples of factors that may affect the auditor's assessment of inherent and control risk.

Audit Risk

.56 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on audit risk and materiality as they relate to planning and performing an audit. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person relying on the financial statements. Some factors to be considered in establishing materiality levels for estimates such as loss reserves are the company's operating results and the company's financial position. The auditor should also consider the measurement bases that external financial statement users will focus on when making decisions. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.57 SAS No. 47 states that the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are material to the financial statements are detected. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, provides specific 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 caused by fraud. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.58 SAS No. 82 requires the auditor to assess the risk of material misstatement due to fraud and consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both (a) misstatements arising from fraudulent financial reporting and (b) misstatements arising from misappropriation of assets in the following categories:

Fraudulent Financial Reporting

- Management's characteristics and influence over the control environment.
- Industry conditions.
- Operating characteristics and financial stability.

Misappropriation of Assets

- Susceptibility of assets to misappropriation.
- Controls.

[Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.59 In addition to requiring the auditor to assess the risk of material misstatement due to fraud, SAS No. 82 provides guidance on how the auditor responds to the results of that assessment, provides guidance on the evaluation of audit test results as they relate to the risk of material misstatement due to fraud, describes related documentation requirements, and provides guidance regarding the auditor's communication about fraud to management, the audit committee, and others. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.60 SAS No. 47 defines audit risk as "the risk that the auditor may unknowingly fail to appropriately modify his opinion on financial statements that are materially misstated." In other words, audit risk is the risk that the auditor will give an unqualified opinion on financial statements that are materially incorrect. SAS No. 47 states that audit risk consists of three components (see paragraphs .61 through .63 below). [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.61 *Inherent Risk.* Inherent risk is the susceptibility of an assertion to a material misstatement, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related balances or classes than for others. In addition to those factors that are peculiar to a specific assertion for an account balance or class of transactions, factors that relate to several or all of the balances or classes may influence the inherent risk related to an assertion for a specific balance or class. Loss reserves generally are based on subjective judgments about the occurrence of certain events that have not yet been fully reported, developing trends, and the outcome of future events. Due to the subjectivity and inherent imprecision involved in making such judgments, estimating loss reserves requires considerable analytical ability and an extensive understanding of the business. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.62 *Control Risk.* Control risk is the risk that a material misstatement that could occur in an assertion will not be prevented or detected on a timely

basis by the entity's controls. That risk is a function of the effectiveness of the design and operation of controls in achieving the entity's broad control objectives relevant to an audit of the entity's financial statements. Some control risk will always exist because of the inherent limitations of internal control. The degree of control risk associated with significant accounting estimates is usually greater than the risk for other accounting processes because accounting estimates involve a greater degree of subjectivity, are less susceptible to control, and are more subject to management influence. It is difficult to establish controls over errors in assumptions or estimates of the future outcome of events in the same way that controls can be established over the routine accounting for completed transactions. In addition, there is a potential for management to be biased about their assumptions; accordingly, a high level of professional skepticism should be exercised by the auditor. The likelihood that loss reserve estimates will contain misstatements of audit importance can be reduced by using competent people in the estimation process and by implementing practices to enhance the reasonableness of estimates, such as requiring that persons making the estimates retain documented explanations and other support for assumptions and methodologies used, and perform retrospective tests of past performance. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.63 Detection Risk. Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion. Detection risk is a function of the effectiveness of an auditing procedure and of its application by the auditor. It arises partly from uncertainties that exist when the auditor does not examine 100 percent of an account balance or class of transactions and partly because of other uncertainties that exist even if he or she were to examine 100 percent of the balance or class. Such other uncertainties arise because an auditor might select an inappropriate auditing procedure, misapply an appropriate procedure, or misinterpret the audit results. These other uncertainties can be reduced to a negligible level through adequate planning and supervision and conduct of a firm's audit practice in accordance with appropriate quality control standards. Due to the relatively high inherent and control risk associated with loss reserves, detection risk is significant in the audit of loss reserves but may be mitigated by adequate planning, supervision, and conduct of the audit. Adequate planning should identify the existing inherent and control risk factors so that they may be adequately addressed in the audit. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Materiality

.64 SAS No. 47 provides guidance on audit risk and materiality as they relate to planning and performing an audit. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person relying on the financial statements. Some factors to be considered in establishing materiality levels for loss reserve estimates are the company's operating results and the company's financial position. The auditor should also consider the measurement bases that external financial statement users will focus on when making decisions. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Chapter 4

AUDITING LOSS RESERVES

Auditing the Claims Data Base

.65 The historical experience of an insurance entity is generally the primary source of information on which loss reserve estimates are based; therefore, the creation of reliable data bases, within an insurance company, is extremely critical to the determination of loss reserve estimates. When evaluating loss reserves, the auditor should consider the reliability of the historical information generated by the insurance company. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.66 The auditor should determine what historical data and methods have been used by management in developing the loss reserve estimate and whether he or she will rely on the same data or other statistical data in evaluating the reasonableness of the loss reserve estimate. After identifying the relevant data, the auditor should obtain an understanding of the controls related to the completeness, accuracy, and classification of the loss data; assess control risk for assertions about loss reserves; and determine the nature, timing, and extent of substantive tests that will be performed for these assertions. Because claim data and characteristics such as dates and type of loss can significantly influence reserve estimation, the auditor should test the completeness, accuracy, and classification of the claim loss data. Chapter 4 and exhibit B-2 in appendix B of the audit guide provide more extensive guidance on auditing the claims cycle. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Evaluating the Reasonableness of the Estimate

Selecting an Audit Approach

.67 SAS No. 57 states that the auditor should obtain an understanding of how management developed the accounting estimates included in the financial statements. The loss reserve estimate is a significant estimate on the financial statements of an insurance entity. Accordingly, regardless of the approach used to audit the loss reserve estimate, the auditor should gain an understanding of how management developed the estimate. The auditor should use one or a combination of the following approaches in evaluating the reasonableness of the accounting estimates:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimate.
- c. Review subsequent events or transactions occurring prior to completion of fieldwork.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.68 When auditing loss reserve estimates, usually approach *a*, *b*, or a combination of the two is used. Normally, approach *c* alone is insufficient to provide reasonable assurance because claims are usually reported to insurance companies and settled over a period of time extending well beyond a normal opinion date. However, approach *c* may provide additional information concerning the reasonableness of loss reserve estimates, particularly for short-tail lines of business, when used in combination either with approach *a* or *b* or with both. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.69 When planning the audit, the auditor chooses to use either approach *a* or *b*, or a combination of both approaches, depending on his or her expectation of what approach will result in sufficient competent evidential matter in the most cost-effective manner. Either approach can be used and, depending on client circumstances, either approach may be effective. However, when management has not used the services of a loss reserve specialist in developing its loss reserve estimate, approach *a*, reviewing and testing management's process, is not appropriate. In this circumstance, approach *b*, developing an independent expectation, should be used. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Reviewing and Testing the Process Used by Management to Develop the Estimate

.70 The auditor may assess the reasonableness of an accounting estimate by performing procedures to test the process used by management to make the estimate. This approach may be appropriate when loss reserve estimates are recommended by an outside loss reserve specialist and management accepts those recommendations, when loss reserve specialists employed by the company are responsible for recommending the estimates, or when both outside and internal specialists are used. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.71 A company that uses an outside loss reserve specialist to develop loss reserve recommendations may engage the specialist to evaluate only the company's major lines of business or only certain components of the loss reserves. In either circumstance, the auditor should determine whether a different approach is needed for auditing the items not reported on by the loss reserve specialist. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.72 If the auditor reviews and tests the process used by management to develop its estimate, and management's estimate differs significantly from the recommendations developed by its specialists, appropriate procedures should be applied to the factors and assumptions that resulted in the difference between management's estimate and the specialists' recommendations. Such procedures should include discussion with management and its specialists. It is management's responsibility to record its best estimate of loss reserves in the financial statements. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.73 SAS No. 57 identifies the following as procedures the auditor may consider performing when using this approach. Some of the procedures listed

below apply to the process management uses to supply data to the loss reserve specialist, some apply to the process used by the specialist to develop recommendations, some apply to the process used by management to review and evaluate those recommendations, and some apply to the process management uses to translate the specialist's recommendations into the loss reserve estimates recorded in the financial statements.

a. *Identify whether there are controls over the preparation of accounting estimates and supporting data that may be useful in the evaluation.* Controls over the preparation of accounting estimates may include—

- Procedures for selecting independent loss reserve specialists or hiring internal specialists, including procedures for determining that the specialist has the requisite competence in loss reserving, knowledge of the company's types of business, and understanding of the different methods available for calculating loss reserve estimates.
- Procedures for reviewing and evaluating the recommendations of the loss reserve specialist.
- Procedures to ensure that the methods used to calculate the loss reserve estimate are appropriate and sufficient in the circumstances.

Controls over the preparation of supporting data, in addition to those discussed in chapter 4 and exhibit B-2 in appendix B of the audit guide, may include—

- Procedures for verifying that data used by the loss reserve specialist is appropriately summarized and classified from the company's claims data base.
- Procedures for ensuring that data actually used by the loss reserve specialist is complete and accurate.
- Procedures to substantiate and determine the appropriateness of industry or other external data sources used in developing assumptions (for example, data received from involuntary risk pools).

b. *Identify the sources of data and factors that management used in forming the assumptions, and consider whether such data and factors are relevant, reliable, and sufficient for the purpose, based on information gathered in other audit tests.* Sources of data and factors used may include—

- Company historical claims data from its own data bases, including changes and trends in the data.
- Company information on reinsurance levels and changes from prior years' reinsurance programs.
- Data received from involuntary risk pools such as the National Council on Compensation Insurance.
- Industry loss data from published sources.
- Internal company experience or information from published sources concerning recent trends in socioeconomic factors affecting claim payments, such as—

- General inflation rates and specific inflation rates for medical costs, wages, automobile repair costs, and the like.
- Judicial decisions assessing liability.
- Judicial decisions regarding noneconomic damages.
- Changes in legislation affecting payment levels and settlement practices.

Consider whether the company's data is sufficient to have adequate statistical credibility (e.g., to allow the "law of large numbers" to work for the company's estimates). Consider whether the types of industry data used in developing assumptions are relevant to the company's book of business, considering policy limits, reinsurance retention, geographic and industry concentrations, and other appropriate factors.

- c. *Consider whether there are additional key factors or alternative assumptions about the factors.* Key factors and potential alternative assumptions that might be considered include—
- Changes in the company's experience or trends in loss reporting and settlements. Increases in the speed of the settlement of claims may lead to assumptions that paid development levels will be lower in the future, or may indicate changes in the company's procedures for processing claims that could lead to increased development in the future.
 - Divergence in company experience relative to industry experience. Such divergence might later result in company development experience that reduces the divergence or might be indicative of a change in a company's experience with a book of business.
 - Changes in a company's practices and procedures relating to recording and settling claims.
 - A company's reinsurance programs and changes therein.
 - Changes in a company's underwriting practices such as new or increased use of managing general agents.
 - New or changed policy forms or coverages.
 - Recent catastrophic occurrences.
- d. *Evaluate whether the assumptions are consistent with each other, the supporting data, relevant historical data, and industry data.* Assumptions that should be evaluated include not only explicit assumptions but also the assumptions inherent in various loss projection methods.
- Paid loss projection methods assume that a company's historical experience relating to the timeliness of settlement will be predictive of future results.
 - Reported (incurred) loss development projection methods assume that a company's experience in estimating case-basis reserves will be repeated in the future.

- e. *Analyze historical data used in developing the assumptions to assess whether it is comparable and consistent with data of the period under audit, and consider whether the data is sufficiently reliable for the purpose.* Consider whether the company's past methods of estimating loss reserves have resulted in appropriate estimates and whether current data (for example, current-year development factors) indicate changes from prior experience. Consider how known changes in the company's loss reporting procedures and settlement practices have been factored into the estimate. Consider how changes in reinsurance programs, in the current period and during historical periods, have been factored into management's estimates.
- f. *Consider whether changes in the business or industry may cause other factors to become significant to the assumptions.* Consider such changes as—
- New lines of business and classes of business within lines.
 - Changes in reinsurance programs.
 - Changes in the regulatory environment, such as premium rate rollbacks and regulation.
 - Changes in the method of establishing rates and changes in methods of underwriting business.
- g. *Review available documentation of the assumptions used in developing the accounting estimates, inquire about any other plans, goals, and objectives of the entity, and consider their relationship to the assumptions.* A company's practices concerning loss settlement, such as a practice of vigorously defending suits or of quickly settling suits, can have a significant effect on a company's loss experience.
- h. *Consider using the work of a specialist regarding certain assumptions.* Using the work of a specialist is discussed in SAS No. 73, *Using the Work of a Specialist*, and in paragraphs .98 through .100 of this SOP.
- i. *Test the calculations used by management to translate the assumptions and key factors into the accounting estimate.* Consider whether all lines of business and accident years are included in the loss reserve estimate. Consider how reinsurance recoverable, salvage, and subrogation have been included.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Developing an Independent Expectation of the Estimate

.74 Based on his or her understanding of the facts and circumstances, the auditor may independently develop an expectation of the estimate by using other key factors or alternative assumptions about those factors. This approach is required whenever management has not used the services of a loss reserve specialist in developing its loss reserve estimate and may be appropriate to assist the auditor in assessing the variability of the loss reserve estimates, even when management does use a loss reserve specialist. The auditor frequently develops independent projections because this method may result in a more cost-effective method of obtaining sufficient competent evidential matter. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.75 When this approach is used, the auditor should¹ use an outside loss reserve specialist (the auditor may also be a loss reserve specialist) to develop the independent expectation of the loss reserve estimate. The use of a specialist is discussed in paragraphs .98 through .100 of this SOP. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Analytical Procedures

.76 Various analytical procedures may be used in the evaluation of loss reserve trends and data, such as the analysis of—

- Loss ratios.
- Loss frequency and severity statistics.
- Claim cost by exposure units.
- Adequacy/redundancy of prior year reserves.
- Average case reserves.
- Claim closure rates.
- Paid to incurred ratios.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.77 Such analyses include comparison of trends and data with industry averages or other expectations. Evaluation would normally be performed by line of business and accident or report year. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Loss Reserve Ranges

.78 As stated in SAS No. 57:

Estimates are based on subjective as well as objective factors and, as a result, judgment is required to estimate an amount at the date of the financial statements. Management's judgment is normally based on its knowledge and experience about past and current events and its assumptions about conditions it expects to exist and courses of action it expects to take.

Accordingly, loss reserves may develop in a number of ways and a reserve for a particular line of business or accident year may prove to be redundant or deficient when analyzed in a following period. Loss reserves considered to be adequate in prior periods may need to be adjusted at a later date as a result of events outside the control of the insurance company that create the need for a change in estimate. Such events include future court decisions and periods of inflation, in which rates may change significantly from period to period and affect the payout of claims. As a result of the circumstances described above, the need to adjust loss reserve estimates in future periods because of future events that are not predictable at the balance sheet date should not be interpreted as evidence of an error or poor loss reserving practices in the past. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.79 Because the ultimate settlement of claims is subject to future events, no single loss reserve estimate can be considered accurate with certainty. An audit approach should address the inherent variability of loss reserve estimates and the effect of that variability on audit risk. The development of a single loss reserve projection, by itself, does not address the concept of variability and may not provide sufficient evidence to evaluate the reasonableness of the loss reserve provision in the financial statements. An analysis of the reasonableness of loss reserve estimates ordinarily should include an analysis of the amount of variability in the estimate. One way to perform this analysis is to consider a range of loss reserve estimates bounded by a high and a low estimate. The high and low ends of the range should not correspond to an absolute best-and-worst-case scenario of ultimate loss settlements, because such estimates may be the result of unlikely assumptions. The range should be realistic and therefore should not include the set of all possible outcomes but instead only those outcomes that are considered reasonable. Extreme projections should be critically analyzed and, if appropriate, be adjusted, given less credence, or discarded (this would apply to projections outside a cluster of other logical projections that fall within a narrower range). [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.80 Another way to address the variability of the loss reserve estimate is to develop a best estimate and to supplement it with qualitative analysis that addresses the variability of the estimate. Qualitative analysis involves consideration of the factors affecting the variability of loss reserves and integrating such factors into a determination of the range of reasonable estimates around a best estimate. Such factors, among others, include the mix of products underwritten, losses incurred by the insurance industry for similar coverages and underwriting years, and the correlation between past and current business written. In any analysis, a thorough working knowledge of the risk factors is a prerequisite to setting a realistic range. Whether the auditor prepares a formal reserve range or a selected estimate, factors affecting the variability of the recorded loss reserve should be considered. The audit procedures performed for this purpose will vary based on the characteristics of the business, the controls the company uses to monitor such variability, and other audit procedures used. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.81 The size of the loss reserve range will vary by line of business. For example, automobile physical damage claims may be estimated with greater precision than product liability claims. In extreme cases, the top-to-bottom range could extend to 50 percent and upward of the amount provided. An example of an extreme case might be a newly formed company that writes primarily volatile types of business. The results of operations in such a situation are sensitive to future fluctuations since the loss reserve estimate is based primarily on assumptions that will undoubtedly change over time. More important, however, is the strain that any extremely adverse loss development would place on such a company's surplus. In an opposite extreme case, the top-to-bottom range might only be 5 percent of the amount provided for a company that only writes automobile physical damage coverages. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.82 When evaluating the variability of loss reserves for an entity, the auditor should be aware that variability within an individual risk group or line of business may be mitigated by the variability within other risk groups or lines

of business. In other words, it is unlikely that ultimate claim settlements for each line of business will fall at the same end of the range. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Risk Factors and Developing a Range

.83 Because loss reserves represent both reported and unreported claims that have occurred as of the valuation date, the auditor needs to gain an understanding of the company's exposure to risk through the business it writes as well as an understanding of environmental factors that may affect the company's loss development at the valuation date. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.84 Some risk factors existing within the company that may affect the variability of the company's loss reserves are—

- *The frequency and severity of claims associated with a line of business.* Medical malpractice, directors' and officers' liability, and other lines of business that typically produce few claims with large settlement amounts tend to have a high degree of variability.
- *Policy characteristics.* Individual lines of business can be written on different policy forms. For example, loss reserving and its related variability for medical malpractice written on an occurrence basis will differ markedly when the policy is written on a claims-made basis, especially during the early years of conversion from an occurrence to a claims-made basis.
- *Retention levels.* The greater a company's retention level, the more variable the results are likely to be. This increased variability is due to the effect that one or several large losses can have on the overall book of business. For reinsurance assumed, the concepts analogous to retention levels are referred to as attachment points and limits.
- *The mix of a company's business with respect to long-tail liability lines and short-tail property lines.* Typically, loss reserves on business with longer tails exhibit greater variability than on business with shorter tails because events affecting ultimate claim settlements may occur at a later date.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.85 Some external factors that may affect the variability of loss reserves are—

- Catastrophes or major civil disorders.
- Jury awards and social inflation arising from the legal environment in principal states in which a company's risks are underwritten.
- The effect of inflation.

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.86 Other risk factors that may affect the variability of loss reserve estimates are described in the Appendix [paragraph .107] of this SOP. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.87 The auditor should obtain an understanding of both internal and external risk factors. This may be accomplished by a review of contracts, inquiries of underwriters, a review of pertinent trade publications, and any other procedures deemed necessary under the circumstances. The auditor should consider these factors in evaluating a reasonable loss reserve range. The best estimate may not necessarily be midway between the highest and lowest estimates in the range, because certain factors (for example, risk retention limits and retrospectively rated contracts) may reduce the variability at one end of the range but not at the other. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.88 When analyzing the variability of loss reserves, the auditor should be aware of potential offsets that may serve to reduce the financial statement effects of misstatements in the recorded loss reserves. Two common examples are ceded reinsurance and retrospectively rated contracts (primary or reinsurance). Such offsets, if material, should be included in an analysis of reserve ranges to quantify the true income statement or balance sheet effect that results from an increase or decrease in loss reserves. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.89 As noted previously in the discussion of internal risk factors and per-risk retention levels, a lower net retention level typically would translate into a lower variability of reserves. In addition, the auditor should consider the workings of all significant reinsurance ceded contracts and the effect that these contracts have on best estimates and high and low points in a range. In considering the effect of reinsurance ceded agreements on loss reserves, the auditor should also consider the effect on ceded reinsurance premiums. See paragraphs .104 through .106 of this SOP for a discussion of the effects of ceded reinsurance on loss reserve estimates. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.90 A retrospectively rated feature in an insurance contract means that increases or decreases in incurred losses may be wholly or partially offset by changes to earned but unbilled premiums. As a result of such a clause, an increase in loss reserves may lead to a receivable for additional premiums while a decrease in loss reserves may be offset by a reduction in premiums. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Evaluating the Financial Effect of a Reserve Range

.91 To determine the amount of variability that is significant to the financial statements, the financial leverage of a company should be analyzed. Financial leverage refers to items such as reserve-to-surplus ratios. The financial position of a company with a 2-to-1 reserve-to-surplus ratio is less affected by variability in its loss reserves than is a company operating at a 4-to-1 ratio. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.92 Additionally, an analysis comparing the difference between recorded loss reserves and the high and low ends of a range with key financial statement balances, such as surplus or recorded loss reserves, might be performed. Combining financial leverage with other materiality factors pertinent to the

company (for example, loan covenant agreements) may provide insights into the amount of variability that is acceptable to the auditor. Because of the imprecise nature of estimating loss reserves, the acceptable range of loss reserve estimates will generally be higher than that of a more tangible balance such as accounts receivable or payable. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.93 According to SAS No. 47, "If the auditor believes the estimated amount included in the financial statements is unreasonable, he should treat the difference between the estimate and the closest reasonable estimate as a likely misstatement and aggregate it with other likely misstatements." Therefore, if the recorded loss reserve is outside the realistic range, the difference between the recorded reserve and the nearer end of the realistic reserve range should be treated as an audit difference. This audit difference should be considered with any other audit differences to evaluate the materiality of the effects on the financial statements. If the difference is deemed material, the auditor should first ask management for additional information that may have been overlooked in the original evaluation. Then, if still necessary, the auditor should attempt to persuade management to make an appropriate adjustment. If management does not make an appropriate adjustment, the auditor should consider modifying his or her report on the financial statements. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.94 SAS No. 47 also states, "Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement." Accordingly, if the recorded loss reserve is within the reasonable range developed by the auditor, an audit adjustment may not be appropriate. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.95 The significance of the variability within a realistic reserve range should also be evaluated against the financial statements. If the difference between the company's recorded reserve and the farther end of the reserve range is deemed significant, the auditor should consider extending audit procedures to obtain additional evidential matter relating to the reserve estimate. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.96 Management must select a single loss reserve estimate that represents its judgment about the most likely circumstances and events. If management develops a reasonable range, the amount recorded should be the best estimate within that range. The auditor should obtain an understanding of the process used by management in arriving at this estimate. In determining the reasonableness of loss reserves, the auditor also should consider the consistency of reserve estimates and any changes in the degree of conservatism of recorded reserves. A change in the degree of conservatism of management's estimate may be indicative of a change in management's reserve process. SAS No. 32, *Adequacy of Disclosure in Financial Statements*, discusses the auditor's responsibility to consider whether the financial statements include adequate disclosure of material matters in light of the circumstances and facts of which the auditor is aware. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Auditor Uncertainty About the Reasonableness of Management's Estimate and Reporting Implications

.97 Ordinarily, the auditor would look to historical data to obtain evidential matter that will provide reasonable assurance that management's estimate of loss reserves is reasonable in the circumstances. Such historical data may not currently exist for certain new companies, for companies writing significant amounts of new lines of business, or for companies with a low volume of claims. When the historical data is not sufficient to resolve uncertainty about the reasonableness of management's estimate of loss reserves and the auditor is unable to resolve that uncertainty through other means, the auditor should consider whether management has adequately disclosed the uncertainty in the notes to the financial statements as required by FASB Statement No. 5, *Accounting for Contingencies*, and paragraphs 4 and 6 of FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and SOP 94-6. A matter involving an uncertainty is one that is expected to be resolved at a future date at which time conclusive evidential matter concerning its outcome would be expected to become available. Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertion about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate. If the auditor is unable to obtain sufficient evidential matter 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. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Use of Specialists by Auditors in Evaluating Loss Reserves

.98 It is the auditor's responsibility to evaluate the reasonableness of the loss reserve established by management. The procedures that the auditor should consider in evaluating the reasonableness of the loss reserve are described in SAS No. 57. One of the procedures the auditor may consider in evaluating the reasonableness of the loss reserve is using the work of a special-

ist. SAS No. 73 provides guidance to the auditor who uses the work of a specialist in performing an audit of financial statements. It states that the auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. The Statement also states that the auditor should evaluate the relationship of the specialist to the client, including circumstances that might impair the specialist's objectivity. When a specialist does not have a relationship with the client, the specialist's work usually will provide the auditor with greater assurance of reliability. Although SAS No. 73 does not preclude the auditor from using the work of a specialist who is related to the client, because of the significance of loss reserves to the financial statements of insurance companies and the complexity and subjectivity involved in making loss reserve estimates, the audit of loss reserves requires the use of an outside loss reserve specialist, that is, a specialist who is not an employee or officer of the company. The term *loss reserve specialist* is defined in paragraphs .44 and .45 of this SOP. When the auditor has the requisite knowledge and experience in loss reserving, the auditor may serve as the loss reserve specialist. If the auditor does not possess the level of competence in loss reserving to qualify as a loss reserve specialist, the auditor should use the work of an outside specialist. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.99 In accordance with SAS No. 73, whenever the auditor uses the work of a specialist, the auditor should fulfill certain fundamental requirements. The auditor should satisfy himself or herself concerning the professional qualifications and reputation of the specialist by inquiry or other procedures. The auditor also should consider the relationship, if any, of the specialist to the client. An understanding should be established between the auditor, the client, and the specialist as to the scope and nature of the work to be performed by the specialist and the form and content of the specialist's report. The auditor has the responsibility to obtain an understanding of the methods or assumptions used by the specialist to determine whether the findings of the specialist are suitable for corroborating representations in the financial statements. These responsibilities apply to all the situations described in paragraph .100. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.100 The following are descriptions of situations involving the presence or absence of a loss reserve specialist in management's determination of loss reserves and the recommended response by the auditor in each situation.

Situation 1—The company has no loss reserve specialist involved in the determination of loss reserves.

Auditor response to situation 1—As stated in paragraph .47, this situation may constitute a reportable condition and possibly a material weakness in the internal control. The auditor should use an outside loss reserve specialist to develop an independent expectation of the loss reserve estimate recorded by the company.

Situation 2—The company has an in-house loss reserve specialist who is involved in the determination of loss reserves and the company does not use an outside loss reserve specialist.

Auditor response to situation 2—The auditor would be required to use an outside loss reserve specialist to evaluate the reasonableness of the company's loss reserve estimate.

Situation 3—The company has no in-house specialist but involves an outside loss reserve specialist in the determination of loss reserves.

Auditor response to situation 3—The auditor should evaluate the relationship, if any, of the specialist to the company. If the specialist is related to the client, the auditor should perform additional procedures with respect to some or all of the specialist's assumptions, methods, or findings to determine that the findings are not unreasonable or should use an outside specialist for that purpose.

Situation 4—The company involves an in-house loss reserve specialist in the determination of loss reserves and involves an outside loss reserve specialist to separately review the loss reserves.

Auditor response to situation 4—The auditor could use the separate review performed by the outside loss reserve specialist.

[Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Evaluating the Reasonableness of Loss Adjustment Expense Reserves

.101 Evaluation of the reasonableness of LAE reserves involves many of the same skills that are needed to evaluate the reasonableness of loss reserves; therefore, such an evaluation ordinarily requires the use of an outside loss reserve specialist. Frequently, both ALAE reserves and ULAE reserves are calculated based on formulas related to paid losses; therefore, in conjunction with the audit of loss adjustment expenses, the auditor should perform sufficient procedures to obtain assurance about the reliability of the paid-loss data. Although ALAE and ULAE frequently are calculated using formulas based on paid losses, they are calculated differently; accordingly, different procedures are used in the evaluation of these two types of reserves. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.102 In most circumstances, a development test cannot be used as a test of the reasonableness of the ULAE reserve. The reasonableness of the ULAE reserve is primarily dependent on the application of sound techniques of cost accounting and expense allocation. The basis of this allocation should be reviewed by the auditor because the way that the company allocates its expenses will have an effect on the ULAE reserve calculation. This review should focus on the allocation of costs to the loss adjustment classification as well as the allocation within that classification to the individual lines of business. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Ceded Reinsurance Receivable

.103 This section discusses certain concepts and procedures that the auditor should be aware of to make a proper evaluation of the reasonableness of reinsurance receivable. This section does not address the following items, which are discussed in detail in the audit guide. Reference should be made to the audit guide for information about—

- The purpose and nature of reinsurance.
- Forms and types of reinsurance.
- Generally accepted accounting practices for reinsurance transactions.

- Internal control structure considerations relating to ceded and assumed reinsurance and a description of audit procedures to verify the integrity of recorded transaction data pursuant to such agreements.

[Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Understanding an Insurance Company's Reinsurance Program

.104 The audit guide recommends that the auditor obtain an understanding of an insurance company's reinsurance program to properly perform audit procedures to verify the accuracy and completeness of recorded cessions and assess the ability of reinsurers to meet their financial obligations under such agreements. This understanding is also essential to properly evaluate the reasonableness of reinsurance receivable balances. The scope of this understanding should not be limited to the reinsurance program currently in effect but should also include reinsurance program(s) in effect during historical periods from which loss experience will be used to project current year net ultimate losses and reinsurance recoveries. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.105 Net loss development patterns will vary to the extent that current reinsurance arrangements (coverages, levels of retention, and type and form of reinsurance) differ from arrangements in effect during the claim experience period used to project losses. Accordingly, the effect of such differences on reinsurance receivables will need to be carefully assessed by the auditor. The level of complexity involved in making this assessment is largely dependent on the types of reinsurance used and the amount of experience available under the program. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

.106 Special difficulties arise in estimating reinsurance receivable on excess of loss reinsurance arrangements in which claim frequency is sporadic, retention levels have changed, and aggregate excess of loss arrangements is used. Estimates of reinsurance receivables are generally easiest for primary coverages (first dollar coverage of either property or casualty business). Additionally, relying on expected loss ratios as a guide for estimating recoveries on excess reinsurance arrangements will not be very helpful if the pricing of such arrangements has varied from year to year with little correlation to the underlying economics of these agreements. Some companies separately project reinsurance receivable on IBNR by stratifying the data base by size of loss. [Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

Appendix

Inherent and Control Risk Factors Affecting Loss Reserves

This Appendix describes various factors that may affect the auditor's assessment of inherent and control risk when auditing insurance entities' loss reserves.

Factors Affecting Inherent Risk

- A company's product mix may have a significant effect on the variability of loss reserves. It is more difficult to estimate loss reserves for long-tail lines of business than it is to estimate reserves for short-tail lines of business because events affecting ultimate claim settlement amounts will occur at a later date.
- New products or new types of risks generally will add to the subjectivity of the loss reserving process because of the company's lack of experience with the new product and relative lack of relevant historical data.
- Deductibles, policy limits, and the retention level of specific lines of business may have a significant effect on the volatility of losses to be settled.
- Policy lines with a low frequency and high severity of claim settlements may exhibit more variability than policy lines associated with a high frequency and low severity of claim settlements.
- Future inflation may result in ultimate loss settlements different from the amounts originally anticipated.
- Social inflation, which arises from the legal environment, as well as recent jury awards have the potential to increase ultimate loss settlements.
- The level and consistency of backlogs in processing claims affect the stability of loss reserve analyses.
- The degree of management's optimism or skepticism when establishing loss reserve assumptions may lead to fluctuations in reserves.
- The introduction of new policy forms may result in an unanticipated expansion of coverage. In addition, the company may lack historical data for losses under the new policy forms.
- Changes in regulations may cause insurance companies to change their claims adjusting practices; for example, a change in regulations may require an increase in the waiting period before workers' compensation benefits begin, or "bad faith" claim settlement laws may alter settlement practices.
- Catastrophic or unusual losses may distort historical experience. Reserves for catastrophic losses, particularly losses that occur near the end of the period, are difficult to estimate.

- Insurance company cash flow considerations may result in a change in loss payment practices.

Factors Affecting Control Risk

- The quality and experience of personnel reviewing a company's loss reserves affect the overall control environment. For example, a company that employs a qualified actuary or an experienced loss reserve specialist to review reserves is usually better equipped to estimate loss reserves than is a company that uses a less qualified individual to perform that task.
- The proper functioning of controls over claim processing will reduce the possibility of error in the data underlying loss reserve estimates. The risk of error in the claims data base will be minimized if controls are functioning as designed.
- The completeness and accuracy of a company's data base will affect the risk of misstatement in assertions about loss reserves.
- The accuracy and reliability of claims data received from outside sources (cedants, reinsurers, voluntary and involuntary risk pools, etc.) will also affect the risk of misstatement in assertions about loss reserves.
- The adequacy of information and data produced by a company is critical in projecting loss reserves. For example, a company capable of accumulating only basic data on premium and loss experience generally poses a greater risk, all other things being equal, than does a company that is capable of accumulating and analyzing more sophisticated data.
- Significant decentralization of operations and reliance on intermediaries may increase control risk.
- A high level of delegation of claims processing or adjusting functions to intermediaries or outside adjusters, without adequate supervision, may result in inefficient claim handling and inappropriate case reserve estimates.
- Changes in delegated responsibilities may result in changes in claims settlement patterns and thereby invalidate historical claim experience.
- The quality of a company's underwriting and claims staff and its knowledge of the industry and control over the company's exposure to loss will have a significant effect on the loss reserving process.
- Existing manual or computerized systems may not be able to cope with a change in the volume of claims.
- Changes in the insurance company's claims processing system may invalidate the historical data used to develop and evaluate loss reserves. Types of changes that may have this result include—
 - Changes in claim classification, such as counting claimants instead of counting claims, considering reopened claims as IBNR claims rather than as development on reported claims, and changing the definition of claims closed without payment.

- Changes in settlement patterns, such as slowing down the payment of claims to increase the holding period of investable assets or speeding up the payment of claims to decrease the effects of inflation.
- Changes in case reserving methodologies, either explicit or implicit, such as a change from estimating case basis reserves on an ultimate cost basis to estimating case-basis reserves on a current cost basis.
- Changes in computerized information systems that result in faster or slower recognition and payment of claims.

[Paragraph renumbered and revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, April 1998.]

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(1990–1991)**

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Also, the contributions of Arnold Brousell and Carolyn Monchelli are greatly appreciated.

[The next page is 30,761.]

Section 11,250

Statement of Position 92-8 Auditing Property/Casualty Insurance Entities' Statutory Financial Statements—Applying Certain Requirements of the NAIC Annual Statement Instructions

October, 1992

NOTE

This Statement of Position presents the recommendations of the Insurance Companies Committee regarding the audit of property/casualty insurance entities' statutory financial statements in applying certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions. It has been reviewed by the chairman of the Auditing Standards Board for consistency with auditing standards. AICPA members may have to justify departures from the recommendations in this Statement of Position if their work is challenged.

Applicability

.01 This statement of position (SOP) provides guidance on the impact of certain requirements of the National Association of Insurance Commissioners' (NAIC's) Annual Statement Instructions—Property and Casualty on the auditor's procedures in the audit of statutory financial statements of property/casualty insurance entities.

Introduction

.02 The NAIC's Annual Statement Instructions direct property/casualty insurers to require their independent certified public accountants to subject the current Schedule P-Part 1 (excluding those amounts related to bulk and incurred-but-not-reported [IBNR] reserves and claim counts) to the auditing procedures applied in the audit of the current statutory financial statements to determine whether Schedule P-Part 1 is fairly stated in all material respects in relation to the basic statutory financial statements taken as a whole. Schedule P-Part 1 includes Part 1-Summary and Part 1A-1R.

.03 Although no separate report on Schedule P-Part 1 is required by the NAIC, the auditor should consider the provisions of SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, and the provisions of this SOP. However, the requirements of this SOP do not preclude an auditor from issuing a report similar to that illustrated in paragraph 12 of SAS No. 29.

Auditing Procedures

.04 Certain of the information in Schedule P-Part 1 is typically subjected to auditing procedures applied in the audit of the basic statutory financial state-

ments (for example, premiums earned and losses paid). Other information not directly related to the basic statutory financial statements is also presented (for example, lines of business classifications for immaterial lines). Although such information may not have been subjected to auditing procedures applied in the audit of the basic statutory financial statements in all instances, such information may have been derived from accounting records that have been tested by the auditor.

.05 Paragraph 7 of SAS No. 29 states that although an auditor is not required by generally accepted auditing standards to apply auditing procedures to information presented outside of the basic financial statements, he or she may choose to modify or redirect certain of the procedures to be applied in the audit of the basic financial statements.

.06 In applying auditing procedures to the information presented in Schedule P-Part 1, the guidance about auditing the claims data base in paragraphs 4.1 and 4.2 of AICPA's SOP 92-4, *Auditing Insurance Entities' Loss Reserves* [section 11,230.61 and .62], applies. The auditor should also refer to chapter 4 and exhibit B-2 in appendix B of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies*.

.07 As stated in paragraph 4.2 of SOP 92-4 [section 11,230.62], because claim data and characteristics such as dates and types of loss can significantly influence reserve estimation, the auditor should test the completeness, reliability, and classification of the claim loss and loss expense data during the audit of the statutory financial statements. In extending those procedures to Schedule P-Part 1, the auditor should determine that—

- a. The data presented on Schedule P-Part 1 is properly reconciled to the statistical records of the company.
- b. Changes between the prior-year and current-year Schedule P-Part 1 are properly reconciled to the current-year audited statutory financial statements.
- c. The source of the data for the auditing procedures applied to the claim loss and loss adjustment expense data during the current calendar year (for example, tests of payments on claims for all accident years that were paid during the current calendar year) is the same as (or reconciles to) the statistical records that support the data presented on Schedule P-Part 1.

.08 If, as a result of the procedures performed during the audit of the statutory financial statements, the auditor becomes aware that Schedule P-Part 1 is not fairly stated in relation to the financial statements taken as a whole, the auditor should communicate to the company's management and the opining actuary that Schedule P-Part 1 is not fairly stated and should describe the misstatement. If the company will not agree to revise Schedule P-Part 1, the auditor should issue a report on Schedule P-Part 1 and should include a description of the misstatement in that report. (The auditor should refer to SAS No. 29 when a report will be issued.) The auditor should consider the impact of a misstatement in Schedule P-Part 1 on the auditor's report on the statutory financial statements.

Effective Date

.09 This SOP is effective for audits of statutory-basis financial statements of property/casualty insurance entities for periods ending after December 15, 1992.

**Insurance Companies Committee
(1991-1992)**

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Section 11,270**Statement of Position 93-5
Reporting on Required Supplementary
Information Accompanying Compiled or
Reviewed Financial Statements of Common
Interest Realty Associations**

April 23, 1993

NOTE

This Statement of Position presents the recommendations of the AICPA Accounting and Review Services Committee on the application of Statements on Standards for Accounting and Review Services to compilations and reviews of financial statements of common interest realty associations. It has been reviewed by the chairman of the Accounting and Review Services Committee for consistency with existing compilation and review standards. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

.01 The American Institute of Certified Public Accountants (AICPA) has issued the Audit and Accounting Guide *Common Interest Realty Associations* (the CIRA guide), which requires common interest realty associations (CIRAs) to disclose certain supplementary information outside the basic financial statements. This requirement also applies to nonpublic CIRAs whose financial statements are compiled or reviewed in accordance with Statements on Standards for Accounting and Review Services (SSARSs). Paragraph 43 of SSARS 1, *Compilation and Review of Financial Statements*, describes the accountant's responsibility when the financial statements are accompanied by information voluntarily presented for supplementary analysis purposes; however, SSARSs do not address the accountant's responsibility when the financial statements are accompanied by required supplementary information. This statement of position (SOP) amends chapter 8, "Review and Compilation Engagements," of the CIRA guide by providing accountants with performance and reporting guidance when required supplementary information accompanies the basic financial statements in a compilation or review engagement.

.02 Paragraph 4.31 of the CIRA guide describes the required supplementary information that should accompany the basic financial statements. That information consists of—

- Estimates of current or future costs of future major repairs and replacements of all existing components, such as roofs, including estimated amounts required, methods used to determine the costs, the basis for calculations (including assumptions, if any, about interest and inflation rates), sources used, and the dates of studies made for this purpose, if any.¹

¹ There is no requirement for CIRAs to obtain studies prepared by professional engineers. Estimates made by the board of directors or estimates obtained from licensed contractors are satisfactory, as discussed in paragraphs 3.06 and 3.07 of the CIRA guide, *Common Interest Realty Associations*.

- A presentation of components to be repaired and replaced, estimates of the remaining useful lives of those components, estimates of current or future replacement costs, and amounts of funds accumulated for each to the extent designated by the board.

.03 When the basic financial statements have been compiled or reviewed, the required supplementary information accompanying the basic financial statements should, at a minimum, be compiled. If the entity chooses to omit the required supplementary information, the guidance in paragraph .06 should be followed. To compile the required supplementary information, the accountant should—

- a. Establish an understanding with the entity regarding the services the accountant will perform with respect to the required supplementary information and how that information will affect the report the accountant expects to render.
- b. Consider what supplementary information is required by the CIRA guide and how that information is to be presented.
- c. Obtain an understanding of how the required supplementary information was developed. This understanding ordinarily includes the following:
 - The source of the information, for example, engineering reports, estimates obtained from licensed contractors, tables in technical manuals on useful lives
 - Whether the required supplementary information is based on current or future replacement costs
 - The interest and inflation rates used to determine funding requirements if the information is based on future replacement costs
- d. Consider whether it will be necessary to perform other accounting services in order to compile the required supplementary information.
- e. Read the required supplementary information and consider whether it appears to be appropriate in form and free from obvious material error.
- f. Obtain additional or revised information, if the accountant becomes aware that the required supplementary information is incorrect, incomplete, or otherwise unsatisfactory.
- g. If the entity is unable or refuses to provide additional or revised information, consider whether a modification of the standard report is adequate to disclose the deficiency in the measurement or presentation of the required supplementary information. If modification of the standard report is adequate to disclose the deficiency, the accountant should follow the guidance in paragraph .05. If modification of the standard report is not adequate to disclose the deficiency, the accountant should withdraw from the engagement.

.04 When the basic financial statements have been compiled or reviewed and the accompanying required supplementary information has been compiled, the accountant should indicate in the report, or in a separate report, the

degree of responsibility he or she is taking for the supplementary information. The report should—

- a. Identify the required supplementary information accompanying the financial statements. (Identification may be by descriptive title or page number of the document.)
- b. State that the supplementary information is not a required part of the basic financial statements but is supplementary information required by the AICPA.
- c. State that the accountant has compiled the accompanying supplementary information from information that is the representation of management, without audit or review.
- d. State that the accountant does not express an opinion or any other form of assurance on the supplementary information.

An example of an additional paragraph that may be added to a compilation report follows:

The [*identify the supplementary information*] on page XX is not a required part of the basic financial statements but is supplementary information required by the American Institute of Certified Public Accountants. We (I) have compiled [*identify the supplementary information*] from information that is the representation of management of XYZ Company, without audit or review. Accordingly, we (I) do not express an opinion or any other form of assurance on the supplementary information.

.05 If, on the basis of facts known to him or her, the accountant becomes aware that the supplementary information has not been measured or presented in accordance with prescribed guidelines, the accountant should indicate in his or her report that the information does not conform to the guidelines and should describe the nature of any material departure(s). An example of a sentence that might be added to the illustrative paragraph presented in paragraph .04 follows:

However, we (I) did become aware that the supplementary information about future major repairs and replacements of common property is not presented in conformity with the guidelines established by the American Institute of Certified Public Accountants because [*describe the material departure from the AICPA guidelines*].

.06 When the compiled or reviewed financial statements are not accompanied by the required supplementary information, a paragraph should be added to the compilation or review report indicating that the required supplementary information has been omitted. The accountant need not present the supplementary information in the accountant's report. The following is an example of a paragraph that the accountant might use in these circumstances:

The American Institute of Certified Public Accountants has determined that supplementary information about future major repairs and replacements of common property is required to supplement, but not required to be a part of, the basic financial statements. The Association has not presented this supplementary information.

.07 In an engagement to review the basic financial statements, the required supplementary information is not subjected to the inquiry and analytical procedures applied in the review of the basic financial statements; therefore,

SSARSs are not applicable to the review of this information. If the accountant has been engaged to review the required supplementary information, he or she may do so in accordance with Statement on Standards for Attestation Engagements No. 1, *Attestation Standards*.

Effective Date

.08 This SOP is effective for compilations and reviews of financial statements for periods ending on or after December 15, 1993. Earlier application is encouraged.

**Accounting and Review Services Committee
(1992-1993)**

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Section 11,280

Statement of Position 93-8 The Auditor's Consideration of Regulatory Risk-Based Capital for Life Insurance Enterprises

December 29, 1993

NOTE

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

Introduction and Scope

.01 Life insurance enterprises operate in a highly regulated environment. The regulation of life insurance enterprises is directed primarily toward safeguarding policyholders' interests and maintaining public confidence in the safety and soundness of the life insurance system. One of the primary tools used by state insurance departments for ensuring that those objectives are being achieved is risk-based capital (RBC).

.02 This Statement of Position (SOP) addresses the auditors' responsibility that arises from the RBC requirements imposed on life insurance enterprises. These RBC requirements affect audits of life insurance enterprises in the following three primary areas:

- a. Audit planning
- b. Going-concern considerations
- c. Other reporting considerations

Overview of Risk-Based Capital

.03 Regulation of life insurance enterprises has historically focused on their capital. The National Association of Insurance Commissioners (NAIC) requires life insurance enterprises to disclose RBC in their statutory filings. The RBC calculation serves as a benchmark for the regulation of life insurance enterprises' solvency by state insurance regulators. RBC requirements set forth dynamic surplus formulas similar to target surplus formulas used by commercial rating agencies. The formulas specify various weighting factors that are applied to financial balances or various levels of activity based on the perceived degree of risk. Such formulas focus on four general types of risk:

- a. The risk related to the insurer's assets (asset or default risk)

- b. The risk of adverse insurance experience with respect to the insurer's liabilities and obligations (insurance or underwriting risk)
- c. The interest rate risk from the insurer's business (asset/liability matching)
- d. All other business risks (management, regulatory action, and contingencies)

The amount determined under such formulas is called the authorized control level RBC (ACLCL).

.04 RBC requirements establish a framework for linking various levels of regulatory corrective action to the relationship of a life insurance entity's total adjusted capital (TAC) (equal to the sum of statutory capital and surplus and such other items, if any, as the NAIC's RBC instructions¹ may provide) to the calculated ACLCL. The levels of regulatory action, the trigger point, and the corrective actions are summarized as follows:

Risk-Based Capital Levels and Corrective Actions

<i>Level</i>	<i>Trigger</i>	<i>Corrective Action</i>
Company Action Level RBC (CALC)	TAC is less than or equal to $2 \times$ ACLCL, or TAC is less than or equal to $2.5 \times$ ACLCL with negative trend	The life insurance enterprise must submit a comprehensive plan to the insurance commissioner.
Regulatory Action Level RBC (RALC)	TAC is less than or equal to $1.5 \times$ ACLCL, or unsatisfactory RBC Plan	In addition to the action above, the insurance commissioner is required to perform an examination or analysis deemed necessary and issue a <i>corrective order</i> specifying corrective actions required.
Authorized Control Level RBC (ACLCL)	TAC is less than or equal to $1 \times$ ACLCL	In addition to the actions described above, the insurance commissioner is permitted but not required to place the life insurance enterprise under regulatory control.
Mandatory Control Level RBC (MCLC)	TAC is less than or equal to $.7 \times$ ACLCL	The insurance commissioner is required to place the life insurance enterprise under regulatory control.

¹ The NAIC's RBC instructions may be amended by the NAIC from time to time in accordance with procedures adopted by the NAIC.

.05 Under the RBC requirements, the comprehensive financial plan should—

- a. Identify the conditions in the insurer that contribute to the failure to meet the capital requirements.
- b. Contain proposals of corrective actions that the insurer intends to take and that would be expected to result in compliance with capital requirements.
- c. Provide projections of the insurer's financial results in the current year and at least the four succeeding years, both in the absence of proposed corrective actions and giving effect to the proposed corrective actions.
- d. Identify the key assumptions impacting the insurer's projections and the sensitivity of the projections to the assumptions.
- e. Identify the quality of, and problems associated with, the insurer's business, including but not limited to its assets, anticipated business growth and associated surplus strain, extraordinary exposure to risk, mix of business, and use of reinsurance in each case, if any.

Audit Planning

.06 The objective of an audit of a life insurance enterprise's financial statements is to express an opinion on whether they present fairly, in all material respects, the enterprise's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles (GAAP). To accomplish that objective, the auditor assesses the risk that the financial statements contain material misstatements and plans and performs audit procedures to provide reasonable assurance that the financial statements are free of material misstatements. Because of the importance of RBC to life insurance enterprises, RBC should be considered in assessing risk and planning the audit. The auditor should ordinarily obtain and review the client's RBC reports and should understand the RBC requirements for preparing such reports and the actual regulations associated with RBC.

Going-Concern Considerations

.07 Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires auditors to evaluate, as part of every audit, whether there is substantial doubt about the ability of the entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the financial statement date. A significant consideration in the auditor's evaluation of a life insurance enterprise's ability to continue as a going concern is whether the enterprise complies with regulatory RBC requirements.²

² Auditors should evaluate a life insurance enterprise's ability to continue as a going concern even if the enterprise meets the minimum RBC standards. There are other conditions and events that may indicate that there could be substantial doubt about a life insurance enterprise's ability to continue as a going concern, such as recurring operating losses, indications of strained liquidity, concerns expressed by regulators, and indications of strained relationships with regulators. However, this SOP discusses only failure to meet RBC standards.

.08 In view of the serious ramifications of noncompliance with regulatory RBC requirements for life insurance enterprises (see paragraph .04), such failure is a condition that indicates that there could be substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. Accordingly, the auditor should obtain information about management's plans that are intended to mitigate the adverse effects of the noncompliance with regulatory RBC capital requirements or events that gave rise to the condition and assess the likelihood that such plans can be implemented. In evaluating management's plans, the auditor should consider—

- a. The life insurance enterprise's existing regulatory capital position.
- b. Whether a comprehensive financial plan has been filed and, if so, whether it has been accepted by the regulators.

.09 The auditor should consider the amount of any RBC capital deficiency. In general, the lower the ratio of total adjusted capital to authorized control level RBC, the greater the doubt about the enterprise's ability to continue as a going concern for a reasonable period. The auditor should, however, also assess the likelihood that the life insurance enterprise's regulatory capital position will improve or deteriorate in the next twelve months.

.10 The auditor should also consider the nature or source (asset quality, underwriting, asset/liability matching, or other) of the deficiency. Curing deficiencies from certain sources may be more within the control of the management of the life insurance enterprise than curing deficiencies from other sources.

.11 Furthermore, the auditor should ascertain whether a comprehensive financial plan has been filed and accepted by the commissioner. If the commissioner has accepted the comprehensive financial plan, the auditor should identify those elements of the comprehensive financial plan that are particularly significant to overcoming the adverse effects of the failure to comply with regulatory RBC requirements and should identify and perform auditing procedures to obtain evidential matter about the significant elements. For example, the auditor should consider the adequacy of support regarding an enterprise's ability to obtain additional capital or a planned disposal of assets. When prospective financial information is particularly significant to management's plans, the auditor should request that management provide the information and should consider the adequacy of support for significant assumptions that underlie it. Further, the auditor should identify those elements of the comprehensive financial plan and conditions placed on the life insurance enterprise by the commissioner that are most difficult to achieve and consider the likelihood that the life insurance enterprise will not be able to implement the elements successfully.

.12 If the commissioner has rejected the comprehensive financial plan, the auditor should consider the commissioner's reasons for rejecting it, any revisions proposed by the commissioner to render the comprehensive financial plan satisfactory, management's intentions for revising the comprehensive financial plan, and possible regulatory sanctions. If the commissioner has not yet notified the insurer whether the comprehensive financial plan has been accepted,³ the auditor should review related communication between the commissioner and the life insurance enterprise and make inquiries of both management and regulatory officials to determine the current status of the

³ The RBC Requirements require the commissioner to notify the insurer whether the comprehensive financial plan is accepted or is unsatisfactory within sixty days of submission of the plan.

comprehensive financial plan. If the life insurance enterprise has not filed a financial plan with the commissioner,⁴ the auditor should make inquiries of management officials about their comprehensive financial plan and their plans for filing.

.13 After the auditor has evaluated management's plans, the auditor should conclude whether substantial doubt about the life insurance enterprise's ability to continue as a going concern for a reasonable period of time remains or is alleviated. This is often a complex judgment requiring considerable professional experience.

Substantial Doubt Remains

.14 If the auditor concludes that substantial doubt about the life insurance enterprise's ability to continue as a going concern for a reasonable period of time remains, the auditor should (a) consider the possible effects on the financial statements and the adequacy of the related disclosures⁵ and (b) modify his or her report.

Independent Auditor's Reports

.15 The auditor's report should either (a) include an explanatory paragraph (following the opinion paragraph) to reflect the auditor's conclusion about the existence of substantial doubt that the entity can continue as a going concern for a reasonable period of time (see paragraph .17) or (b) disclaim an opinion (see paragraph .18).

.16 The illustrative auditors' reports in this SOP are presented to assist auditors in drafting their reports under various RBC circumstances. Each illustration intentionally describes the same general fact situation to avoid suggesting that particular facts always lead to a particular form of opinion. The appropriate form of opinion depends on the auditor's judgment as to the severity and most probable outcome of the matter described.

.17 The following is an illustration of an auditor's report (unqualified opinion) on the financial statements of a life insurance enterprise with an explanatory paragraph added because of the existence of substantial doubt about the enterprise's ability to continue as a going concern.

Independent Auditor's Report⁶

To the Board of Directors and Shareholders
ABC Life Company

We have audited the accompanying balance sheets of ABC Life Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial

⁴ The RBC Requirements require that a comprehensive financial plan be filed with the commissioner within forty-five days of the failure to meet RBC standards.

⁵ Auditors of publicly held life insurance enterprises should consider SEC Financial Reporting Release No. 16, *Rescission of Interpretation Relating to Certification of Financial Statements*, which states, "... filings containing accountants' reports that are qualified as a result of questions about the entity's continued existence must contain appropriate and prominent disclosure of the registrant's financial difficulties and viable plans to overcome these difficulties."

⁶ The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether an explanatory paragraph should be added to their reports.

statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits 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 ABC Life Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

The accompanying financial statements have been prepared assuming that ABC Life Company will continue as a going concern. As discussed in Note XX to the financial statements, [*State of Domicile's Insurance Regulatory Body*] imposes risk-based capital requirements on life insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of Domicile's Insurance Regulatory Body*]. The Company has filed a comprehensive financial plan with the commissioner outlining the Company's plans for attaining the required levels of regulatory capital by December 31, 19XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of ABC Life Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[Signature]

[Date]

.18 SAS No. 59 states that inclusion of an explanatory paragraph (following the opinion paragraph) in the auditor's report as described above serves adequately to inform users of the financial statements of the auditor's substantial doubt. Nonetheless, SAS No. 59 does not preclude the auditor from declining to express an opinion in cases involving uncertainties. If the auditor disclaims an opinion, the uncertainties and their possible effects should be disclosed in an appropriate manner and the auditor's report should state all of the substantive reasons for the disclaimer of opinion. The following is an illustration of an auditor's report containing a disclaimer of opinion as the result of uncertainties relating to an auditor's substantial doubt about a life insurance enterprise's ability to continue as a going concern for a reasonable period of time.

Independent Auditor's Report⁷

To the Board of Directors and Shareholders
XYZ Life Company

We have audited the accompanying balance sheets of XYZ Life Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to report on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits 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 report.

The accompanying financial statements have been prepared assuming that XYZ Life Company will continue as a going concern. As discussed in Note XX to the financial statements, [*State of Domicile's Insurance Regulatory Body*] imposes risk-based capital requirements on life insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of Domicile's Insurance Regulatory Body*]. The Company has filed a comprehensive financial plan with the commissioner outlining its plans for attaining the required levels of regulatory capital by December 31, 19XX. To date, the Company has not received notification from the commissioner regarding acceptance or rejection of its comprehensive financial plan. Failure to meet the capital requirements and interim capital targets included in the Company's plan would expose the Company to regulatory sanctions that may include restrictions on operations and growth, mandatory asset dispositions, and placing the Company under regulatory control. These matters raise substantial doubt about the ability of XYZ Life Company to continue as a going concern. The ability of the Company to continue as a going concern is dependent on many factors, one of which is regulatory action, including ultimate acceptance of the Company's comprehensive financial plan. Management's plans in regard to these matters are described in Note XX. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

Because of the significance of the uncertainty discussed above, we are unable to express, and we do not express, an opinion on the financial statements for the year ended December 31, 19X2.

In our opinion, the 19X1 financial statements referred to above present fairly, in all material respects, the financial position of XYZ Life Company as of December 31, 19X1, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

[Signature]

[Date]

⁷ The circumstances described in the third paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether to disclaim an opinion on financial statements.

Substantial Doubt Alleviated

.19 If the auditor concludes that substantial doubt about the life insurance enterprise's ability to continue as a going concern for a reasonable period of time is alleviated, the auditor should consider the adequacy of disclosure in the financial statements of the principal conditions or events that initially raised the substantial doubt. The auditor should follow the guidance in SAS No. 59, paragraphs .10 and .11. Furthermore, the auditor may wish to add an emphasis of matter paragraph to the auditor's report (see paragraphs .27 and .28, below).

Other Reporting Considerations

Uncertainties

.20 A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by FASB Statement No. 5, *Accounting for Contingencies*, and matters related to estimates covered by SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640]. [Paragraph revised to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.21 Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with GAAP, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter 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. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.22 If the auditor is unable to obtain sufficient evidential matter to support management's assertion 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. A qualified opinion or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.23 Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due to departures from GAAP related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates. [Paragraph added to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.24 The auditor's decision to add an explanatory paragraph to the auditor's report because of the existence of such an uncertainty that affects the financial statements is one that requires a high degree of professional judgment. Prior to considering whether an explanatory paragraph should be added to the auditor's report because of the existence of a material uncertainty, the auditor should have concluded that substantial doubt about the life insurance enterprise's ability to continue as a going concern does not exist (see paragraphs .07 to .19, above). An explanatory paragraph for a material uncertainty should not be used for situations in which the auditor's uncertainty involves substantial doubt about the ability of the life insurance enterprise to continue as a going concern. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.25 Because its resolution is prospective, management generally cannot estimate the effect of the uncertainty on the entity's financial statements. Uncertainties should not be confused with future events that generally are susceptible to reasonable estimation by management in preparing financial statements. If the auditor believes that financial statements are materially misstated as a result of the use of inappropriate accounting principles, the auditor should express a qualified or adverse opinion. A scope limitation should result in a qualified opinion or a disclaimer of opinion. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.26 If the auditor decides to include an explanatory paragraph(s) in the report because of the existence of a material uncertainty that affects the financial statements, the explanatory language should follow the opinion paragraph and should describe the matter giving rise to the uncertainty and indicate that its outcome cannot presently be determined. The explanatory language may be shortened by referring to disclosures made in a note to the financial statements. No reference to the uncertainty should be made in the introductory, scope, or opinion paragraphs of the auditor's report. The following is an illustration of an auditor's report (unqualified opinion) on the financial statements of a life insurance enterprise with an explanatory paragraph because of the existence of a material uncertainty as a result of possible regulatory sanctions.

Independent Auditor's Report⁸

To the Board of Directors and Shareholders
GHI Life Insurance Company

We have audited the accompanying balance sheets of GHI Life Insurance Company as of December 31, 19X2 and 19X1, and the related statements of

⁸ The circumstances described in the fourth paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether an explanatory paragraph should be added to their reports.

income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to report on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits 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 GHI Life Insurance Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

As discussed in Note XX to the financial statements, [*State of Domicile's Insurance Regulatory Body*] imposes risk-based capital requirements on life insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of Domicile's Insurance Regulatory Body*]. The ultimate outcome of this situation cannot presently be determined. Accordingly, no adjustments that may result from the ultimate resolution of this uncertainty have been made in the accompanying financial statements.

[Signature]

[Date]

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

Emphasis of a Matter

.27 In some circumstances, the auditor may wish to emphasize a matter regarding the financial statements, but nevertheless intends to express an unqualified opinion. An example of such a circumstance is the failure to comply with regulatory RBC requirements. Prior to considering whether an emphasis of a matter paragraph should be added to the auditor's report for a failure to comply with regulatory RBC requirements, however, the auditor should have concluded that the matter being emphasized does not create substantial doubt about the life insurance enterprise's ability to continue as a going concern (see paragraphs .07 to .19, above) and does not reflect a material uncertainty (see paragraphs .20 to .26, above). [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

.28 Emphasis of a matter should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing explanation" should not be used in the opinion paragraph in situations of this type. The following is an illustration of an unqualified opinion with an emphasis of a matter paragraph regarding the possible effects of a life insurance enterprise's failure to comply with regulatory RBC requirements on its financial statements.

Independent Auditor's Report⁹

To the Board of Directors and Shareholders
DEF Life Company

We have audited the accompanying balance sheets of DEF Life Company as of December 31, 19X2 and 19X1, and the related statements of income, changes in stockholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits 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 XX to the financial statements, [*State of Domicile's Insurance Regulatory Body*] imposes risk-based capital requirements on life insurance enterprises, including the Company. At December 31, 19X2, the Company's total adjusted capital is at the company action level based on the risk-based capital calculation required by [*State of Domicile's Insurance Regulatory Body*].

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of DEF Life Company as of December 31, 19X2 and 19X1, and the results of its operations and its cash flows for the years then ended in conformity with generally accepted accounting principles.

[*Signature*]

[*Date*]

[Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

Effective Date

.29 This statement of position is effective for audits of life insurance enterprises' financial statements for periods ending after December 15, 1993. [Paragraph renumbered to reflect the conforming changes necessary due to the issuance of recent authoritative literature, June 1998.]

⁹ The circumstances described in the third paragraph of this illustrative report represent assumptions made for purposes of illustration only. They are not intended to provide criteria or other guidelines to be used by independent auditors in deciding whether an emphasis paragraph should be added to their reports.

**Insurance Companies Committee
(1992-1993)**

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Section 11,290

Statement of Position 94-1 Inquiries of State Insurance Regulators

April 20, 1994

NOTE

This Statement of Position (SOP) presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this SOP to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this SOP.

SOP 94-1 is amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*. SOP 01-5 is effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001.

Introduction

.01 This Statement of Position (SOP) addresses the auditor's consideration of regulatory examinations as a source of evidential matter in conducting an audit of an insurance enterprise's financial statements and the auditor's evaluation of material permitted statutory accounting practices.

Applicability

.02 This SOP applies to audits of financial statements of life insurance enterprises,¹ property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies. It amends chapter 2 ("Audit Considerations") of the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies and Life and Health Insurance Entities*.^[2] As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.03 The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as prescribed

¹ FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, clarifies that FASB Statements and Interpretations and Accounting Principles Board (APB) Opinions apply to mutual life insurance enterprises, except when specifically exempted, that prepare financial statements in conformity with generally accepted accounting principles. This SOP applies to audits of mutual life insurance enterprises.

^[2] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of an insurance enterprise should monitor the status of the adoption of the revised Manual by the various state regulatory authorities. [Paragraph added, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

Auditor's Consideration of State Regulatory Examinations

.04 The auditor should consider evaluating "information contained in regulatory or examination reports, supervisory correspondence, and similar materials from applicable regulatory agencies" (Statement on Auditing Standards [SAS] No. 57, *Auditing Accounting Estimates* [AICPA, *Professional Standards*, vol. 1, AU sec. 342]). The auditor may encounter specific information that may raise a question concerning possible illegal acts, such as . . . violations of laws or regulations cited in reports of examinations by regulatory agencies that have been available to the auditor" (SAS No. 54, *Illegal Acts by Clients* [AICPA, *Professional Standards*, vol. 1, AU sec. 317]). Accordingly, it is appropriate that the auditor review examination reports and related communications between regulators and the insurance enterprise to obtain competent evidential matter. [Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.05 The auditor should review reports of examinations and communications between regulators and the insurance enterprise and make inquiries of the regulators. The auditor should—

- Request that management provide access to all reports of examinations and related correspondence including correspondence relating to financial conditions.
- Read reports of examinations and related correspondence between regulators and the insurance enterprise during the period under audit through the date of the auditor's report.
- Inquire of management and communicate with the regulators, with the prior approval of the insurance enterprise, when the regulators' examination of the enterprise is in process or a report on an examination has not been received by the insurance enterprise regarding conclusions reached during the examination.

[Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.06 A refusal by management to allow the auditor to review communications from, or to communicate with, the regulator would ordinarily be a limitation on the scope of the audit sufficient to preclude an unqualified opinion (SAS No. 58, *Reports on Audited Financial Statements* [AICPA *Professional Standards*, vol. 1, AU sec. 508]). A refusal by the regulator to communicate with the auditor may be a limitation on the scope of the audit sufficient to preclude an unqualified opinion, depending on the auditor's assessment of other relevant facts and circumstances. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

Auditor's Consideration of Permitted Statutory Accounting Practices

.07 Prescribed statutory accounting practices are those practices incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the revised Manual in whole, or in part, as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state. [Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.08 Permitted statutory accounting practices include practices not prescribed by the domiciliary state, as described in paragraph .07 above, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (a) if it wishes to depart from the prescribed statutory accounting practices, or (b) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future. [Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.09 Auditors should exercise care in concluding that an accounting treatment is *permitted*, and should consider the adequacy of disclosures in the financial statements regarding such matters.^[3] For each examination, auditors should obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are significant to an insurance enterprise's financial statements are permitted by the domiciliary state regulatory authority. [Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.10 Sufficient competent evidential matter consists of any one or combination of—

- Written acknowledgment sent directly from the regulator to the auditor. (This type of corroboration includes letters similar to attorneys' letters and responses to confirmations.)
- Written acknowledgment prepared by the regulator, but not sent directly to the auditor, such as a letter to the client.
- Direct oral communications between the regulator and the auditor, supported by written memorandum. (If the auditor, rather than the regulator, prepares the memorandum, the auditor should send such memorandum to the regulator to make sure it accurately reflects the communication.)

^[3] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

Auditors should use judgment to determine the type of corroboration that is necessary in the circumstances. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

.11 If the auditor is unable to obtain sufficient competent evidential matter to corroborate management's assertion regarding a permitted statutory accounting practice that is material to the financial statements, the auditor should qualify or disclaim an opinion on the statutory financial statements because of the limitation on the scope of the audit (SAS No. 58 [AU sec. 508]). [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

Effective Dates

.12 The provisions of this SOP as originally issued in 1994 should be applied to audits of financial statements performed for periods ending on or after December 15, 1994. The amendments to this SOP are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. Retroactive application is not permitted. [Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

**Insurance Companies Committee
(1993-1994)**

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Director

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Section 11,300

Statement of Position 95-4 Letters for State Insurance Regulators to Comply With the NAIC Model Audit Rule

November 3, 1995

NOTE

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

Introduction

.01 This Statement of Position (SOP) provides guidance to auditors on the form and content of communications with state insurance regulators. Such communications are required by the National Association of Insurance Commissioners (NAIC) *Annual Statement Instructions Requiring Annual Audited Financial Statements*, which incorporates the January 1991 *Model Rule (Regulation) Requiring Annual Audited Financial Reports* (reissued in July 1995) (hereinafter called the Model Audit Rule). The Model Audit Rule was designed by the NAIC to promote uniformity in state laws and regulations dealing with audits of insurance enterprises' statutory financial statements. Though some states have laws or regulations that differ from the Model Audit Rule, this SOP addresses only the requirements of the Model Audit Rule.

.02 To the extent that the Model Audit Rule is changed in the future, the illustrations in this SOP may need to be changed to reflect the revised provisions of the Model Audit Rule. For example, at the time of this SOP, the NAIC is in the process of codifying statutory accounting practices for certain insurance enterprises. The *Annual Statement Instructions Requiring Annual Audited Financial Statements* currently requires that statutory financial statements be prepared using accounting practices prescribed or otherwise permitted by the insurance department of the state of domicile. It is expected that when the NAIC completes the codification of statutory accounting practices, the Model Audit Rule will be amended to require auditors to express opinions on statutory financial statements as to their conformity with the newly codified statutory accounting principles rather than as to their conformity with statutory accounting practices prescribed or permitted by the insurance department of the state of domicile.

Scope

.03 This SOP applies to audits of financial statements of all insurance companies that file audited financial statements with state insurance departments in accordance with the NAIC's Model Audit Rule. It amends the American Institute of Certified Public Accountants (AICPA) Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*.¹

Conclusions—Form and Content

Awareness

.04 Section 6 of the Model Audit Rule requires that the insurer notify the insurance commissioner of the state of domicile of the name and address of the insurer's independent certified public accountant (hereinafter referred to as *auditor*). In connection with that notification, the insurer is required to obtain an awareness letter from its auditor stating that the auditor—

- a. Is aware of the provisions of the insurance code and the rules and regulations of the insurance department of the state of domicile that relate to accounting and financial matters.
- b. Will issue a report on the financial statements in terms of their conformity to the statutory accounting practices prescribed or otherwise permitted by the insurance department of the state of domicile, specifying exceptions as appropriate.

.05 The following is an illustration of the awareness letter:

To the Board of Directors of ABC Insurance Company:

We have been engaged by ABC Insurance Company (the Company) to perform annual audits in accordance with generally accepted auditing standards of the Company's statutory financial statements. In connection therewith, we acknowledge the following:

We are aware of the provisions relating to the accounting and financial reporting matters in the Insurance Code of [name of state of domicile] and the related rules and regulations of the Insurance Department of [name of state of domicile] that are applicable to audits of statutory financial statements of insurance enterprises. Also, after completion of our audits, we expect that we will issue our report on the statutory financial statements of ABC Insurance Company as to their conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile].

This letter is intended solely for the information and use of the Insurance Department of [name of state of domicile] and other state insurance departments and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

¹ The AICPA has a project under way to prepare an Audit and Accounting Guide *Audits of Life and Health Insurance Entities* which covers audits of mutual life insurance companies as well as stock life insurance companies. The new Audit and Accounting Guide would replace the Industry Audit Guide *Audits of Stock Life Insurance Companies* and would incorporate the guidance in this Statement of Position.

Change in Auditor

.06 Section 6 of the Model Audit Rule requires that insurers notify the insurance department of the state of domicile within five business days of the dismissal or resignation of the auditor for the immediately preceding filed audited statutory financial statements. Within ten business days of that notification, the insurer also is required to provide a separate letter stating whether, in the twenty-four months preceding that event, there were any disagreements, subsequently resolved or not, with the former auditor on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreements, if not resolved to the satisfaction of the former auditor, would have caused the auditor to make reference to the subject matter of the disagreement in connection with the auditor's opinion. The Model Audit Rule requires that the insurer provide the insurance department of the state of domicile a letter from the former auditor to the insurer indicating whether the auditor agrees with the statements in the insurer's letter and, if not, stating the reasons for the disagreement.

.07 The following is an illustration of the change in auditor letter:

To the Board of Directors of DEF Insurance Company:

We previously were auditors for DEF Insurance Company and, under the date of [report date], we reported on the statutory financial statements of DEF Insurance Company as of and for the years ended December 31, 19X1 and 19X0.² Effective [date of termination], we are no longer auditors of DEF Insurance Company. We have read DEF Insurance Company's statements in its letter dated [date of insurer's letter], which is attached hereto, and we agree with the statements therein. [However, if the auditor is (a) not in a position to agree or disagree or (b) does not agree with the insurer's statement, the auditor's letter should state that the auditor is not in a position to agree or disagree or that the auditor does not agree with such statements and give the reasons.]³

Qualifications

.08 Section 12 of the Model Audit Rule requires the auditor to provide a letter to the insurer to be included in the annual financial report stating—

- a. The auditor is independent with respect to the insurer and conforms with the standards of his or her profession as contained in the Code of Professional Conduct and pronouncements of the AICPA and the Rules of Professional Conduct of the appropriate state board of public accountancy.
- b. The background and experience in general and of the individuals used for an engagement and whether each is a certified public accountant.

² If the auditor had not reported on any financial statements, the first sentence should be modified as follows:

We previously were engaged to audit the statutory financial statements of DEF Insurance Company as of and for the year ending December 31, 19X1.

³ The insurer's letter may contain a statement, such as—

In connection with the audits of the statutory financial statements of the Company for the years ended December 31, 19X2 and 19X1, and the subsequent interim period through [date of termination], there were no disagreements with [CPA Firm] on any matter of accounting principles, statutory accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile], financial statement disclosure, or auditing scope or procedures, which disagreements if not resolved to their satisfaction would have caused them to make reference to the subject matter of the disagreement in their reports.

- c. The auditor understands that the annual audited statutory financial statements and his or her opinion thereon will be filed in compliance with the requirement of the Model Audit Rule and that the domiciliary commissioner will be relying on the information in the monitoring and regulating of the financial position of insurers.
- d. The auditor consents to the workpaper requirements contained in the Model Audit Rule and agrees to make the workpapers available for review by the domiciliary commissioner or the commissioner's designee under the auditor's control.⁴
- e. The engagement partner is licensed by an appropriate state licensing authority and is a member in good standing of the AICPA.
- f. The auditor meets the qualifications and is in compliance with the "Qualifications of Independent Certified Public Accountant" section of the Model Audit Rule.

.09 The following is an illustration of the qualification letter:

To the Board of Directors of GHI Insurance Company:

We have audited, in accordance with generally accepted auditing standards, the statutory financial statements of GHI Insurance Company (the Company) for the years ended December 31, 19X1 and 19X0, and have issued our report thereon dated [*date of report*]. In connection therewith, we advise you as follows:

- a. We are independent certified public accountants with respect to the Company and conform to the standards of the accounting profession as contained in the Code of Professional Conduct and pronouncements of the American Institute of Certified Public Accountants, and the Rules of Professional Conduct of the [*state*] Board of Public Accountancy.
- b. The engagement partner and engagement manager, who are certified public accountants, have [] years and [] years, respectively, of experience in public accounting and are experienced in auditing insurance enterprises. Members of the engagement team, most (some) of whom have had experience in auditing insurance enterprises and [X] percent of whom are certified public accountants, were assigned to perform tasks commensurate with their training and experience.
- c. We understand that the Company intends to file its audited statutory financial statements and our report thereon with the Insurance Department of [*name of state of domicile*] and other state insurance departments in states in which the Company is licensed and that the insurance commissioners of those states will be relying on that information in monitoring and regulating the statutory financial condition of the Company.

While we understand that an objective of issuing a report on the statutory financial statements is to satisfy regulatory requirements, our audit was not planned to satisfy all objectives or responsibilities of insurance regulators. In this context, the Company and insurance commissioners should understand that the objective of an audit of statutory financial statements in accordance with generally accepted au-

⁴ Refer to AICPA, *Professional Standards*, vol. 1, AU 9339, *Working Papers: Auditing Interpretations of Section 339*.

ding standards is to form an opinion and issue a report on whether the statutory financial statements present fairly, in all material respects, the admitted assets, liabilities, and capital and surplus, results of operations and cash flow in conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile]. Consequently, under generally accepted auditing standards, we have the responsibility, within the inherent limitations of the auditing process, to plan and perform our audit to obtain reasonable assurance about whether the statutory financial statements are free of material misstatement, whether caused by error or fraud, and to exercise due professional care in the conduct of the audit. The concept of selective testing of the data being audited, which involves judgment both as to the number of transactions to be audited and the areas to be tested, has been generally accepted as a valid and sufficient basis for an auditor to express an opinion on financial statements. Audit procedures that are effective for detecting errors, if they exist, may be ineffective for detecting misstatements resulting from fraud. Because of the characteristics of fraud, particularly those involving concealment and falsified documentation (including forgery), a properly planned and performed audit may not detect a material misstatement resulting from fraud. In addition, an audit does not address the possibility that material misstatements resulting from fraud may occur in the future. Also, our use of professional judgment and the assessment of materiality for the purpose of our audit means that matters may exist that would have been assessed differently by insurance commissioners.

It is the responsibility of the management of the Company to adopt sound accounting policies, to maintain an adequate and effective system of accounts, and to establish and maintain an internal control structure that will, among other things, provide reasonable, but not absolute, assurance that assets are safeguarded against loss from unauthorized use or disposition and that transactions are executed in accordance with management's authorization and recorded properly to permit the preparation of financial statements in conformity with accounting practices prescribed or permitted by the Insurance Department of [name of state of domicile].

The Insurance Commissioner should exercise due diligence to obtain whatever other information that may be necessary for the purpose of monitoring and regulating the statutory financial position of insurers and should not rely solely upon the independent auditor's report.

- d. We will retain the workpapers⁵ prepared in the conduct of our audit until the Insurance Department of [name of state of domicile] has filed a Report of Examination covering 19X1, but not longer than seven years. After notification to the Company, we will make the workpapers available for review by the Insurance Department of [name of state of domicile]

⁵ Section 13 of the Model Audit Rule defines workpapers as follows:

Workpapers are the records kept by the independent certified public accountant of the procedures followed, the tests performed, the information obtained, and the conclusions reached pertinent to the accountant's examination of the financial statements of an insurer. Workpapers, accordingly, may include audit planning documentation, work programs, analyses, memoranda, letters of confirmation and representation, abstracts of company documents and schedules or commentaries prepared or obtained by the independent certified public accountant in the course of his or her examination of the financial statements of an insurer and which support the accountant's opinion.

[Footnote added, September 1997, to reflect the issuance of the Notice to Practitioners on communications with state insurance regulators.]

at the offices of the insurer, at our offices, at the Insurance Department or at any other reasonable place designated by the Insurance Commissioner. Furthermore, in the conduct of the aforementioned periodic review by the Insurance Department of [name of state of domicile], photocopies of pertinent audit workpapers may be made (under the control of the accountant) and such copies may be retained by the Insurance Department of [name of state of domicile].⁶

- e. The engagement partner has served in that capacity with respect to the Company since [year that current "term" started], is licensed by the [state name] Board of Public Accountancy, and is a member in good standing of the American Institute of Certified Public Accountants.
- f. To the best of our knowledge and belief, we are in compliance with the requirements of section 7 of the NAIC's *Model Rule (Regulation) Requiring Annual Audited Financial Reports* regarding qualifications of independent certified public accountants.

This letter is intended solely for the information and use of the Insurance Department of [name of state of domicile] and other state insurance departments and is not intended to be and should not be used by anyone other than these specified parties.

[As amended, September 1997 and September 1998, to reflect the issuance of Notices to Practitioners. Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Notification of Adverse Financial Condition

.10 Section 10 of the Model Audit Rule requires that the auditor notify the insurer's board of directors or audit committee in writing within five business days of a determination that (a) the insurer has materially misstated its financial condition as reported to the domiciliary commissioner as of the balance-sheet date currently under examination or (b) the insurer does not meet the minimum capital and surplus requirements of the state insurance statute as of the balance-sheet date. The Model Audit Rule also requires the insurer to provide (a) to the insurance commissioner of the state of domicile a copy of the notification of adverse financial condition within five days of its receipt and (b) to the auditor evidence that the notification has been provided to the insurance commissioner. If the auditor receives no such evidence, the Model Audit Rule requires the auditor to send the notification to the insurance commissioner directly within the next five business days.

.11 The following is an illustration of the auditor's notification of adverse financial condition letter when the audit is complete:⁷

To the Board of Directors of MNO Insurance Company:

We have audited, in accordance with generally accepted auditing standards, the statutory financial statements of MNO Insurance Company (the Company) as of December 31, 19X1 and 19X0, and have issued our report thereon dated [date of report].

⁶ See footnote 4. [Footnote renumbered, September 1997, to reflect the issuance of the Notice to Practitioners on communications with state insurance regulators.]

⁷ A determination that financial statements filed with a state insurance department contain a material misstatement does not necessarily always occur when an audit is complete. The Model Audit Rule requires notification to be provided within five business days of such determination. The language in this illustrative letter should be modified depending on the relevant facts and circumstances. [Footnote renumbered, September 1997, to reflect the issuance of the Notice to Practitioners on communications with state insurance regulators.]

In connection with our audit, we determined that capital and surplus reflected in the statement of admitted assets, liabilities, and capital and surplus of the Company as of December 31, 19X1, as reported on the 19X1 Annual Statement filed with the Insurance Department of [name of state] is materially misstated because [provide explanation]. Statutory capital and surplus of \$ reported on the 19X1 Annual Statement should be reduced by \$ as a result of the matter in the preceding sentence.⁸

If we do not receive evidence that the Company has forwarded a copy of this letter to the insurance commissioner of [name of state] within five business days of receipt, we are required to give the insurance commissioner a copy of this letter within the next five business days.

This letter is intended solely for the information and use of the Insurance Department of [name of state of domicile] and other state insurance departments and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Report on Internal Controls

.12 Section 11 of the Model Audit Rule requires that insurers provide the insurance commissioner of the state of domicile a written report describing significant deficiencies in the insurer's internal control structure noted during the audit. Auditors should follow the guidance in Statement on Auditing Standards No. 60, *Communication of Internal Control Structure Related Matters Noted in an Audit*. Additionally, the Model Audit Rule requires insurers to provide a description of remedial actions taken or proposed to correct significant deficiencies, if not covered in the auditor's report. The reports on internal controls should be filed by the insurer within sixty days after filing the annual audited financial statements. No report is required to be issued if the auditor does not identify significant deficiencies.

Effective Date

.13 This SOP should be applied to audits of statutory financial statements performed for periods ending on or after December 15, 1995. Early application is encouraged.

⁸ The wording of this paragraph is intended for those situations in which audit adjustments would not cause minimum capital and surplus of an insurer to fall below statutory requirements. The paragraph should be reworded if the company did not meet minimum capital and surplus requirements as presented on its Annual Statement as filed with the domiciliary commissioner. [Footnote renumbered, September 1997, to reflect the issuance of the Notice to Practitioners on communications with state insurance regulators.]

**Insurance Companies Committee
(1994-1995)**

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Section 11,310

Statement of Position 95-5 Auditor's Reporting on Statutory Financial Statements of Insurance Enterprises

December 21, 1995

NOTE

This Statement of Position (SOP) presents the recommendations of the AICPA Insurance Companies Committee regarding the application of generally accepted auditing standards to audits of financial statements of insurance enterprises. Members of the AICPA Auditing Standards Board have found the recommendations in this SOP to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this SOP.

SOP 95-5 is amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification*. SOP 01-5 is effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001.

Introduction and Background

.01 All states require domiciled insurance enterprises to submit to the state insurance commissioner an annual statement on forms developed by the National Association of Insurance Commissioners (NAIC). The states also require that audited statutory financial statements be provided as a supplement to the annual statements. Statutory financial statements are prepared using accounting principles and practices "prescribed or permitted by the regulatory authority of the state of domicile," referred to in this Statement of Position (SOP) as *statutory accounting practices*. Statutory accounting practices are considered an other comprehensive basis of accounting (OCBOA) as described in Statement on Auditing Standards (SAS) No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623). [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.02 The insurance laws and regulations of most states require insurance companies domiciled in those states to comply with the guidance provided in the NAIC *Accounting Practices and Procedures Manual* except as otherwise prescribed by state law. In 1999, the NAIC completed a process to codify statutory accounting practices for certain insurance enterprises, resulting in a revised *Accounting Practices and Procedures Manual* (the revised Manual), effective January 1, 2001. It is expected that all states will require insurers to comply with most, if not all, provisions of the revised Manual. Auditors of an insurance enterprise should monitor the status of the adoption of the revised

Manual by the various state regulatory authorities. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

[.03] [Paragraph deleted by the issuance of Statement of Position 01-5, December 2001.]

Prescribed-or-Permitted Statutory Accounting Practices

.04 Prescribed statutory accounting practices are those practices that are incorporated directly or by reference in state laws, regulations, and general administrative rules applicable to all insurance enterprises domiciled in a particular state. States may adopt the revised Manual in whole or in part as an element of prescribed statutory accounting practices in those states. If, however, the requirements of state laws, regulations, and administrative rules differ from the guidance provided in the revised Manual or subsequent revisions, those state laws, regulations, and administrative rules will take precedence. Auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine the specific prescribed statutory accounting practices applicable in each state. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.05 Permitted statutory accounting practices include practices not prescribed by the domiciliary state as described in paragraph .04, above, but allowed by the domiciliary state regulatory authority. An insurance enterprise may request permission from the domiciliary state regulatory authority to use a specific accounting practice in the preparation of the enterprise's statutory financial statements (a) if it wishes to depart from the state prescribed statutory accounting practices, or (b) if prescribed statutory accounting practices do not address the accounting for the transaction. Accordingly, permitted accounting practices differ from state to state, may differ from company to company within a state, and may change in the future. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

NAIC-Codified Statutory Accounting^[1]

[.06] [Paragraph deleted by the issuance of Statement of Position 01-5, December 2001.]

Other Relevant AICPA Pronouncements

.07 During 1994, the AICPA issued the following two pronouncements that address statutory accounting practices and statutory financial statements. These documents were amended by SOP 01-5, *Amendments to Specific AICPA Pronouncements for Changes Related to the NAIC Codification* [section 10,840].

- a. SOP 94-1, *Inquiries of State Insurance Regulators* [section 11,290], requires, for each audit, auditors to obtain sufficient competent evidential matter to corroborate management's assertion that permitted statutory accounting practices that are material to an insurance enterprise's financial statements are permitted by the regulatory authority of the state of domicile.

[1] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

- b. SOP 94-5, *Disclosures of Certain Matters in the Financial Statements of Insurance Enterprises* [section 10,630], requires insurance enterprises to disclose information about prescribed and permitted statutory accounting practices in their financial statements.

[As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

Applicability

.08 This SOP applies to all audits of statutory financial statements of insurance enterprises that file financial statements with state regulatory authorities, including stock and mutual insurance enterprises. Insurance enterprises that prepare statutory financial statements include life and health insurance enterprises, property and casualty insurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools, syndicates, captive insurance companies, financial guaranty insurance enterprises, health maintenance organizations, and hospital, medical, and dental service or indemnity corporations. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.09 This SOP supersedes SOP 90-10, *Reports on Audited Financial Statements of Property and Liability Insurance Companies*. It also amends the AICPA Audit and Accounting Guides *Audits of Property and Liability Insurance Companies* and *Life and Health Insurance Entities*. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]^[2]

Conclusions

Superseding Statement of Position 90-10, Reports on Audited Financial Statements of Property and Liability Insurance Companies

.10 Auditors should not issue reports on statutory financial statements as to fair presentation in conformity with statutory accounting practices that include a disclaimer of opinion as to fair presentation in conformity with generally accepted accounting principles (GAAP). [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

General-Use Reports

.11 If an insurance enterprise's statutory financial statements are intended for distribution other than for filing with the regulatory authorities to whose jurisdiction the insurance enterprise is subject, the auditor of those statements should use the general-use form of report for financial statements that lack conformity with GAAP (SAS No. 62, *Special Reports* [AICPA, *Professional Standards*, vol. 1, AU sec. 623]). SAS No. 1, section 544, *Lack of Conformity With Generally Accepted Accounting Principles*, paragraph .04 (AICPA, *Professional Standards*, vol. 1, AU sec. 544.04), requires the auditor to use the standard form of report described in SAS No. 58, *Reports on Audited*

^[2] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

Financial Statements (AICPA, *Professional Standards*, vol. 1, AU sec. 508), modified as appropriate because of departures from GAAP. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.12 Although it may not be practicable to determine the amount of difference between GAAP and statutory accounting practices, the nature of the differences is known. The differences generally exist in significant financial statement items, and are believed to be material and pervasive to most insurance enterprises' financial statements. Therefore, there is a rebuttable presumption that the differences between GAAP and statutory accounting practices are material and pervasive. Auditors should express an adverse opinion with respect to conformity with GAAP (AU sec. 508.58), unless the auditor determines the differences between GAAP and statutory accounting practices are not material and pervasive. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.13 The auditor, when expressing an adverse opinion, is required to disclose in a separate explanatory paragraph(s) preceding the opinion paragraph in his or her report (a) all of the substantive reasons for the adverse opinion, and (b) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable³ (AU sec. 508.59 and .60). If the effects are not reasonably determinable, the report should so state, and also should state that the differences are presumed to be material. Furthermore, the notes to the statutory financial statements should discuss statutory accounting practices and describe how those practices differ from GAAP. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.14 After expressing an opinion on the statutory financial statements as to conformity with GAAP, auditors may express an opinion on whether the statutory financial statements are presented in conformity with statutory accounting practices. If departures from statutory accounting practices are found to exist and are considered to be material, the auditors should express a qualified or adverse opinion on the statutory financial statements just as they would under SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508) regarding conformity with GAAP.^[4] [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.15 Following is an illustration of an independent auditor's report on the general-use financial statements of an insurance enterprise prepared in conformity with statutory accounting practices, which contains an adverse opinion as to conformity with GAAP, and an unqualified opinion as to conformity with statutory accounting practices. In this illustrative report, it is assumed that the effects on the statutory financial statements of the differences between GAAP and statutory accounting practices are not reasonably determinable.

³ SAS No. 32, *Adequacy of Disclosure in the Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 431), defines practicable as "the information is reasonably obtainable from management's accounts and records and that providing the information in his report does not require the auditor to assume the position of a preparer of financial information." For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the auditor's report.

^[4] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

Independent Auditor's Report

To the Board of Directors
ABC Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of ABC Insurance 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. 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],^[5] which practices differ from generally accepted accounting principles. The effects on the financial statements of the variances between 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 Insurance Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows 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 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.

[As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

Limited-Use Reports

.16 Prescribed-or-permitted statutory accounting practices for insurance enterprises are considered an OCBOA as described in SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 623). If an insurance enterprise's statutory financial statements are intended solely for filing with state regulatory authorities to whose jurisdiction the insurance enterprise is subject, the auditor may use the form of report for financial statements prepared in accordance with a comprehensive basis of accounting other than GAAP. Such reporting is appropriate even though the auditor's report may be made a matter of public record (AU sec. 623.05f). However, that paragraph further states that limited-use reports may be used only if the financial statements and

^[5] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001].

report are intended solely for filing with the regulatory agencies to whose jurisdiction the insurance enterprise is subject. The auditor's report should contain a statement that there is a restriction on the use of the statutory financial statements to those within the insurance enterprise and for filing with the state regulatory authorities to whose jurisdiction the insurance enterprise is subject. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.17 Although auditing standards do not prohibit an auditor from issuing limited-use and general-use reports on the same statutory financial statements of an insurance enterprise, it is preferable to issue only one of those types of reports. Few, if any, insurance enterprises that do not prepare financial statements in conformity with GAAP will be able to fulfill all of their reporting obligations with limited-use statutory financial statements. [As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.18 Following is an illustration, adapted from paragraph 8 of SAS No. 62 (AICPA, *Professional Standards*, vol. 1, AU sec. 623.08), of an unqualified auditor's report on limited-use financial statements prepared in conformity with statutory accounting practices.

Independent Auditor's Report

To the Board of Directors
XYZ Insurance Company

We have audited the accompanying statutory statements of admitted assets, liabilities, and surplus of XYZ Insurance Company as of December 31, 20X2 and 20X1, and the related statutory statements of income and changes in surplus, and cash flow, 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 more fully in Note X to the financial statements, these financial statements were prepared in conformity with accounting practices prescribed or permitted by the Insurance Department of the State of [state of domicile],^[6] 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.

^[6] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

This report is intended solely for the information and use of the board of directors and the management of XYZ Insurance Company and state insurance departments to whose jurisdiction the company is subject and is not intended to be and should not be used by anyone other than these specified parties.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature. As amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

[.19] [Paragraph deleted by the issuance of Statement of Position 01-5, December 2001.]

General-Use and Limited-Use Reports

.20 The notes accompanying an insurance enterprise's statutory financial statements should contain a summary of significant accounting policies that discuss statutory accounting practices and describe how this basis differs from GAAP (AU sec. 623.10). In general-use statutory financial statements, the effects of the differences should be disclosed, if quantified. However, in limited-use statutory financial statements, the effects of the differences need not be quantified or disclosed. [Paragraph added, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.21 The auditor should consider the need for an explanatory paragraph (or other explanatory language) under the circumstances described in SAS No. 58 (AU sec. 508.11) and SAS No. 62 (AU sec. 623.31) regardless of any of the following:

- a. The type of report—general-use or limited-use
- b. The opinion expressed—unqualified, qualified, or adverse
- c. Whether the auditor is reporting as to conformity with GAAP or conformity with the statutory accounting practices

For example, in a general-use report, an auditor may express an adverse opinion as to conformity with GAAP and an unqualified opinion as to conformity with the statutory accounting practices, and also conclude there is a need to add an explanatory paragraph regarding substantial doubt about the insurance enterprise's ability to continue as a going concern; such paragraph should follow both opinion paragraphs. [Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.22 The auditor may wish to emphasize a matter in a separate paragraph of the auditor's report (AU secs. 508.37 and 623.31). When an insurance enterprise prepares its financial statements using accounting practices prescribed or permitted by the regulatory authority of the state of domicile and has significant transactions that it reports using permitted accounting practices that materially affect the insurance enterprise's statutory capital,^[7] the auditor is strongly encouraged to include an emphasis-of-a-matter paragraph in the report describing the permitted practices and their effects on statutory

^[7] [Footnote deleted by the issuance of Statement of Position 01-5, December 2001.]

capital. [Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.23 An example of an emphasis-of-a-matter paragraph follows:

As discussed in Note X to the financial statements, the Company received permission from the Insurance Department of the [state of domicile] in 20XX to write up its home office property to appraised value; under prescribed statutory accounting practices home office property is carried at depreciated cost. As of December 31, 20X5, that permitted accounting practice increased statutory surplus by \$XX million over what it would have been had the prescribed accounting practices been followed.

[Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.24 If subsequent to the initial adoption of the revised Manual there has been a change in accounting principles or in the method of their application that has a material effect on the comparability of the company's financial statements, the auditor should refer to the change in an explanatory paragraph of the report (AU sec. 508.16). The explanatory paragraph (following the opinion paragraph) should identify the nature of the change and refer to the note in the financial statements that discusses the change. The auditor's concurrence with a change is implicit, unless the auditor takes exception to the change in expressing the opinion as to the fair presentation of the financial statements in conformity with GAAP or the statutory accounting practices. [Paragraph added, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

.25 An example of an explanatory paragraph follows:

As discussed in Note X to the financial statements, the Company changed its method of accounting for guaranty funds and other assessments.

[Paragraph added, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

Mutual Life Insurance Enterprises

.26 In April 1993, the Financial Accounting Standards Board (FASB) issued Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, which concludes that mutual life insurance enterprises can no longer issue statutory financial statements that are described as "in conformity with generally accepted accounting principles." Interpretation No. 40, as amended by FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*, is effective for financial statements issued for fiscal years beginning after December 15, 1995. (FASB Statement No. 120 does not change the disclosure and other transition provisions of Interpretation No. 40.) For statutory financial statements of mutual life insurance enterprises issued before that effective date, auditors may report on the statutory financial statements as being in conformity with generally accepted accounting principles. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

Effective Dates

.27 The provisions of this SOP as originally issued in 1995 should be applied to audits of statutory financial statements for years ended on or after December 31, 1996. The amendments to this SOP are effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001. Retroactive application is not permitted. [Paragraph renumbered and amended, effective for audits of statutory financial statements for fiscal years ending on or after December 15, 2001, by Statement of Position 01-5.]

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The AICPA gratefully acknowledges the contributions to this SOP by Gary W. Roubinek, the former chair of the Insurance Companies Committee, and Dionne D. McNamee, former staff aide to the Insurance Companies Committee.

[The next page is 31,025.]

Section 11,320

Statement of Position 98-3
Audits of States, Local Governments, and
Not-for-Profit Organizations Receiving
Federal Awards

March 17, 1998

NOTE

This Statement of Position presents the recommendations of the AICPA Single Audit Working Group regarding the performance of audits in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This edition incorporates guidance contained in the 1994 revision to *Government Auditing Standards*, as amended, and Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

This SOP reflects relevant auditing guidance contained in authoritative pronouncements through May 1, 2000, as follows:

- SAS No. 90, *Audit Committee Communications*
- 1994 revision to *Government Auditing Standards* Amendment No. 2, *Auditor Communication*

Users of this SOP should consider pronouncements issued subsequent to those listed above to determine their effect on entities covered by this SOP.

Summary

This Statement of Position (SOP) provides guidance on the auditor's responsibilities when conducting a single audit or program-specific audit in accordance with the Single Audit Act Amendments of 1996 and Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations* (June 1997 revision). This SOP supersedes SOP 92-9, *Audits of Not-for-Profit Organizations Receiving Federal Awards*, and part VII, "Audits of Federal Financial Assistance," of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units*.

In addition to providing an overview of the auditor's responsibilities in an audit of federal awards, this SOP—

- Describes the applicability of the Single Audit Act Amendments of 1996 and Circular A-133.
- Describes the auditor's responsibility for testing and reporting on the schedule of expenditures of federal awards.

- Describes the auditor's responsibility for considering internal control and for performing tests of compliance with applicable laws, regulations, and program compliance requirements under generally accepted auditing standards, *Government Auditing Standards*, and Circular A-133.
- Describes the auditor's responsibility for reporting and provides examples of the reports required by *Government Auditing Standards* and Circular A-133.
- Describes the auditor's responsibility for testing and reporting in a program-specific audit.

Further, this SOP incorporates guidance from the following documents:

- The Single Audit Act Amendments of 1996 and Circular A-133
- AICPA Statement on Auditing Standards No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*
- 1994 revision to *Government Auditing Standards*, as amended
- The OMB Circular A-133 *Compliance Supplement* (June 1997 revision)

This edition of the SOP includes conforming changes for relevant auditing pronouncements through May 1, 2000, as presented in the earlier Note.

Chapter 1

INTRODUCTION AND OVERVIEW

Introduction

Purpose and Applicability

1.1 The purpose of this Statement of Position (SOP) is to provide auditors of states, local governments, and not-for-profit organizations (NPOs) that receive federal awards with a basic understanding of the procedures they should perform and of the reports they should issue for single audits and program-specific audits under—

- a. The Single Audit Act Amendments of 1996 (hereinafter referred to as the Single Audit Act or the Act).¹
- b. Office of Management and Budget (OMB) Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*,² and the related *OMB Circular A-133 Compliance Supplement*.
- c. The standards applicable to financial audits contained in the 1994 revision of *Government Auditing Standards*, as amended (also referred to as the Yellow Book), issued by the Comptroller General of the United States of the U.S. General Accounting Office (GAO).³ These standards, which are periodically amended and codified, incorporate the fieldwork and reporting standards of generally accepted auditing standards (GAAS)⁴ issued by the American Institute of Certified Public Accountants (AICPA).

1.2 This SOP provides guidance about financial and compliance auditing standards and requirements related to single audits (chapters 1 through 10) and program-specific audits (chapter 11) for entities (also referred to as auditees) subject to the Single Audit Act and Circular A-133. Applicable standards and requirements are promulgated by the OMB, GAO, and AICPA. This SOP also provides guidance on applicable auditing standards and requirements established by those organizations to assist auditors in planning, performing, and reporting on single audits and program-specific audits in

¹ The Single Audit Act Amendments of 1996 (Public Law 104-156) was enacted into law in July 1996 and replaced the Single Audit Act of 1984. A reprint of the Single Audit Act Amendments of 1996 is included in appendix A of this SOP.

² Circular A-133 (as revised on June 30, 1997), is reprinted in appendix B of this SOP.

³ The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

⁴ GAAS requirements are discussed in this SOP to the extent necessary to explain the related requirements of *Government Auditing Standards*. Auditors should refer to relevant AICPA Statements on Auditing Standards and also related Audit and Accounting Guides such as *Not-for-Profit Organizations*, *Health Care Organizations*, and *Audits of State and Local Governmental Units* for additional information on GAAS requirements.

accordance with those standards and requirements, and includes illustrative audit reports. Since Circular A-133 is the federal policy guidance to which auditors are held in performing single audits, this SOP will primarily focus on its requirements.

1.3 This SOP is organized by chapters in which the important considerations in performing single audits and program-specific audits are discussed (see table of contents).

1.4 This SOP is not a complete manual of procedures, nor should it supplant the auditor's judgment about the audit work required in particular situations. Because of the variety of federal, state, and local financial assistance programs and the complexity of the regulations that govern them, the procedures included in this SOP cannot cover all the circumstances or conditions that would be encountered in the audits of every entity. The auditor should use professional judgment to tailor his or her procedures to meet the conditions of the particular engagement, so that the audit objectives may be achieved.

1.5 Auditors should be aware that certain states have imposed additional audit requirements related to state or local financial assistance. The guidance in this SOP does not extend to individual state requirements (except for the guidance in paragraphs 3.49, 3.58, and 6.71). Furthermore, pass-through entities may impose additional audit requirements on their subrecipients related to the financial assistance passed through. The guidance in this SOP also does not extend to those requirements.

Definitions

1.6 The terms used in this SOP are intended to be consistent with the definitions in the Single Audit Act and Circular A-133. Similarly, the term *not-for-profit organization* as used in this SOP is consistent with the definition of the term *non-profit organization* in Circular A-133 (see appendix B) and includes not-for-profit institutions of higher education, hospitals, and other health care providers.

Effective Dates

1.7 The requirements of the Single Audit Act and Circular A-133 are effective for audits of fiscal years beginning after June 30, 1996. This SOP also includes relevant auditing guidance through AICPA Statement on Auditing Standards (SAS) No. 90, *Audit Committee Communications* (AICPA, *Professional Standards*, vol. 1, AU secs. 380 and 722). The effective dates of this auditing guidance should be applied as provided for in the related literature. This SOP does not change the effective dates of the auditing standards, the act, and Circular A-133. The remaining provisions of this SOP are applicable to audits of fiscal years beginning after June 30, 1996, in which the related fieldwork commences on or after March 1, 1998. Earlier application is encouraged.

Objectives of a Single Audit

1.8 A single audit has two main objectives: (a) an audit of the entity's financial statements and the reporting on the schedule of expenditures of federal awards in relation to those financial statements and (b) a compliance audit of federal awards expended during the fiscal year. Each of these results in the preparation and issuance of certain audit reports (see paragraph 2.7 for a more detailed description of the audit objectives).

Audit of Entity's Financial Statements and Reporting on the Schedule of Expenditures of Federal Awards

1.9 The financial statement audit required by Circular A-133 is performed in accordance with the standards applicable to financial audits contained in *Government Auditing Standards* and GAAS, and it results in the auditor reporting on the entity's financial statements and on the scope of the auditor's testing of compliance and internal control over financial reporting and presents the results of those tests. The primary sources of guidance and standards regarding financial statement audits are the AICPA Statements on Auditing Standards (SASs), particularly SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801); *Government Auditing Standards*; and the following AICPA Audit and Accounting Guides, as applicable: *Not-for-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*.⁵ Refer to chapter 4 for a more detailed discussion of financial statement audit considerations under Circular A-133. Guidance on reporting on the schedule of expenditures of federal awards is provided in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Refer to chapter 5 for a more detailed discussion of the schedule of expenditures of federal awards.

Compliance Audit of Federal Awards

1.10 Under Circular A-133, the auditor has additional testing and reporting responsibilities for compliance, as well as internal control over compliance, beyond a financial statement audit performed in accordance with *Government Auditing Standards* and GAAS. The compliance audit of federal awards expended during the fiscal year provides a basis for issuing an additional report on compliance related to major programs and on internal control over compliance.⁶ The various types of federal awards and payment methods are described in paragraphs 1.17 through 1.23. Compliance auditing considerations applicable to major programs and internal control over compliance are discussed in chapters 6 and 8. Reporting is discussed in chapter 10.

Adherence to Professional Standards and Requirements

1.11 The auditor should be aware that AICPA Ethics Interpretation 501-3, *Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits*, states that when an auditor undertakes an audit of government grants or recipients of government monies and agrees to follow specified government audit standards, guides, procedures, statutes, rules, and regulations, he or she is obligated to follow these standards or guidelines in addition to GAAS. Failure to do so is an act discreditable to the profession and a violation of rule 501 of the AICPA Code of Professional Conduct, unless it is disclosed in the auditor's report that these rules were not followed and the reasons for doing so are given.

⁵ Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

⁶ A major program is defined in Circular A-133. See the discussion of the determination of major programs in chapter 7.

Relationship of the Single Audit Act, Circular A-133, Government Auditing Standards, and GAAS

1.12 The Single Audit Act Amendments of 1996 were enacted to streamline and improve the effectiveness of audits of federal awards and to reduce the audit burden on states, local governments, and NPOs. Those goals were achieved, in part, by increasing the dollar threshold for requiring a single audit to \$300,000 in federal awards expended from \$25,000 in federal awards received and introducing a risk-based approach for determining which federal programs are to be considered major programs (see paragraph 2.2 for a further discussion of the audit threshold). The Single Audit Act requires single audits and program-specific audits of federal awards to be performed in accordance with *Government Auditing Standards*,⁷ and gives the Director of OMB the authority to develop government-wide guidelines and policy on performing audits to comply with the Act. The OMB established audit guidelines and policy in Circular A-133, which was revised and issued June 30, 1997,⁸ and establishes a uniform system of auditing states, local governments, and NPOs that expend federal awards. (Chapter 2 provides an overview of Single Audit Act and Circular A-133 requirements.) Circular A-133 has been adopted in regulation by individual federal departments and agencies.

1.13 In performing audits in accordance with the standards applicable to financial audits contained in *Government Auditing Standards*, the auditor assumes certain responsibilities beyond those of audits performed in accordance with GAAS.⁹ *Government Auditing Standards* includes general standards, incorporates the fieldwork and reporting standards under GAAS, and includes additional fieldwork and reporting standards. *Government Auditing Standards* includes additional standards in such areas as quality control reviews, continuing professional education, documentation requirements, auditor communication, working papers, and audit follow-up (see paragraphs 3.8 through 3.23 for a detailed discussion of the additional standards). The reporting responsibilities in *Government Auditing Standards* require additional reporting on compliance and on internal control over financial reporting (see paragraphs 3.23, 10.15, and 10.16 for a detailed discussion of the reporting requirements).

⁷ *Government Auditing Standards* includes standards for financial audits as well as for performance audits. The references to *Government Auditing Standards* in this SOP encompass only the standards applicable to financial audits and not the performance audit standards (see footnote 3). However, *Government Auditing Standards* states that auditors should follow, as appropriate, the report contents standards for objectives, scope, and methodology; audit results; the view of responsible officials; and its report presentation standards. A discussion of these standards is contained in the performance auditing standards in chapter 7 of *Government Auditing Standards* (see paragraph 10.21).

⁸ The June 30, 1997, revision to Circular A-133 superseded OMB Circular A-128, *Audits of State and Local Governments*, and all previous versions of Circular A-133.

⁹ Paragraphs 21 through 23 of SAS No. 74 describe the auditor's responsibility when he or she has been engaged to perform an audit in accordance with GAAS and becomes aware that the entity is subject to an audit requirement that may not be encompassed in the terms of the engagement. In such a situation, SAS No. 74 requires that the auditor communicate to management and the audit committee, or to others with equivalent authority or responsibility, that an audit in accordance with GAAS alone may not satisfy the relevant legal, regulatory, or contractual requirements. That communication may be oral or written. However, if the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including the potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions in relation to the guidance in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316).

Compliance Testing

1.14 Table 1.1 presents the relationship among the compliance testing requirements of GAAS, Government Auditing Standards, the Single Audit Act, and Circular A-133. Compliance testing requirements are discussed in detail in chapter 6. SAS No. 74 provides general guidance on the auditor's responsibility for compliance auditing under GAAS, *Government Auditing Standards*, and federal audit requirements. In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit is described. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316), and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 312), as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors.

Internal Control Consideration

1.15 Table 1.2 presents the relationship among the requirements to consider internal control under GAAS, *Government Auditing Standards*, the Single Audit Act, and Circular A-133. Internal control requirements are discussed in detail in chapters 4 and 8.

Table 1.1

Compliance Testing

	<i>Fieldwork Responsibilities</i>	<i>Reporting Responsibilities</i>
Generally accepted auditing standards	Design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 54, <i>Illegal Acts by Clients</i> , as described in SAS No. 74, <i>Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance</i> , and to provide reasonable assurance about whether the financial statements are free of material misstatements (whether caused by error or fraud), as described in SAS No. 82, <i>Consideration of Fraud in a Financial Statement Audit</i> , and SAS No. 47, <i>Audit Risk and Materiality in Conducting an Audit</i> .	Requires the auditor to adequately inform the audit committee or others with equivalent authority and responsibility about any illegal acts that the auditor becomes aware of during the audit unless they are clearly inconsequential. 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 that causes a material misstatement of the financial statements should be reported directly to the audit committee. When the auditor identifies fraud risk factors that have continuing control implications, the auditor should communicate those factors that are considered reportable conditions to senior management and the audit committee. See SAS No. 82, paragraphs 38 through 40, for an additional discussion of the reporting requirements of SAS No. 82.
<i>Government Auditing Standards</i>	Same responsibilities as required by GAAS, but <i>Government Auditing Standards</i> specifically states that auditors should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance with provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statement amounts. <i>Government Auditing Standards</i> also requires auditors to communicate information to certain parties during the planning stages of an audit regarding the nature and extent of planned testing and reporting on compliance with laws and regulations.	Requires a written report describing the scope of the auditor's testing of compliance with laws and regulations and presenting the results of those tests (additional details on the reporting responsibilities are included in paragraphs 10.15, 10.16, and 10.21 through 10.25).
Single Audit Act and Circular A-133	Determine whether the entity complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that have a direct and material effect on each major program.	Requires the auditor to express an opinion on whether the entity complied with laws, regulations, and with the provisions of contracts or grant agreements which could have a direct and material effect on each major program and, where applicable, refer to a separate schedule of findings and questioned costs.

Table 1.2**Internal Control Responsibilities**

	<i>Fieldwork Responsibilities</i>	<i>Reporting Responsibilities</i>
Generally accepted auditing standards	Obtain an understanding of internal control over financial reporting sufficient to plan the audit by performing procedures to understand both the design of controls relevant to an audit of financial statements and whether they have been placed in operation, and assess control risk, in accordance with SAS No. 55, <i>Consideration of Internal Control in a Financial Statement Audit</i> , as amended by SAS No. 78, <i>Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55</i> .	Requires the auditor to communicate, either orally or in writing, any reportable conditions as described in SAS No. 60, <i>Communication of Internal Control Related Matters Noted in an Audit</i> .
<i>Government Auditing Standards</i>	Same responsibilities as GAAS except that <i>Government Auditing Standards</i> requires additional documentation requirements when assessing control risk at maximum for controls significantly dependent upon computerized information. <i>Government Auditing Standards</i> also requires auditors to communicate information to certain parties during the planning stages of an audit regarding the nature and extent of planned testing and reporting on internal control over financial reporting. <i>Government Auditing Standards</i> also provides additional guidance on safeguarding of assets and control over compliance with laws and regulations.	Requires a written report describing the scope of the auditor's testing of internal control and presenting the results of those tests. Also requires separate identification and written communication of all reportable conditions, including those reportable conditions that are individually or cumulatively material weaknesses.
Single Audit Act and Circular A-133	With regard to internal control over compliance, the auditor is required to do the following (in addition to the requirements of <i>Government Auditing Standards</i>): (1) perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, (2) plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program,* and (3) perform tests of internal control (unless the internal control is likely to be ineffective in preventing or detecting noncompliance).	Requires a written report on internal control over major programs describing the scope of testing internal control and the results of the tests, and, where applicable, referring to a separate schedule of findings and questioned costs.

* Circular A-133 requires the auditor to plan the audit to support a low assessed level of control risk for major programs; however, it does not actually require the achievement of a low assessed level of control risk. See paragraphs 8.16 through 8.22.

Reporting

1.16 A matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133 appears in table 1.3. Reporting is discussed in detail in chapter 10.

Table 1.3

<i>Report</i>	<i>Required by—</i>		
	<i>GAAS</i>	<i>Government Auditing Standards</i>	<i>Circular A-133</i>
Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards	X	X	X
Report on compliance and on internal control over financial reporting based on an audit of financial statements		X	X
Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or disclaimer of opinion] on compliance)			X
Schedule of findings and questioned costs			X

Types of Federal Awards and Payment Methods**Definition of Federal Awards**

1.17 Circular A-133 defines federal awards as *federal financial assistance* and *federal cost-reimbursement contracts* that auditees receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts (under grants or contracts) used to buy goods or services from vendors. See paragraph 2.15 for a discussion of subrecipient and vendor determinations.

Federal Financial Assistance—Classification and Types

1.18 Federal sponsors have classified federal financial assistance into program categories in the *Catalog of Federal Domestic Assistance* (CFDA), published by the Government Printing Office. Circular A-133 defines federal programs as all federal awards under the same CFDA number. Certain clusters of federal programs should be treated as one program for determining major programs. Research and development, student financial aid, and certain other programs are defined as a cluster in the *OMB Circular A-133 Compliance Supplement* because they are closely related and share common compliance requirements (see paragraphs 1.26 through 1.28 and chapters 2 and 6 for additional discussion of the *Compliance Supplement*).

1.19 Sometimes state governments combine funding from different federal awards in providing assistance to their subrecipients when the awards are

closely related programs and share common compliance requirements. In this case, Circular A-133 states that the state may require the subrecipient to treat the combined federal awards as a cluster of programs. See paragraph 2.18 for further information.

1.20 There are over 1,000 individual grant programs and several distinct types of federal award payment methods. Many of these programs are described in the CFDA; however, certain programs may not be included. For example, contracts may not be listed in the CFDA. Circular A-133 states that when a CFDA number is not assigned, all federal awards from the same agency that are made for the same purpose should be combined and considered one program.

1.21 Programs in the CFDA are classified into fifteen types of assistance. Benefits and services are provided through seven financial and eight nonfinancial types of assistance. The following list describes the eight principal types of assistance that are available.

- *Formula grants.* For activities of a continuing nature not confined to a specific project, allocations of money to nonfederal entities are made in accordance with a distribution formula prescribed by law or administrative regulation. One example is the Department of Agriculture's award to land-grant universities for cooperative extension services. Another example is the Department of Justice's award to state and local governments for drug control and systems improvement.
- *Project grants.* These involve the funding (for fixed or known periods) of specific projects, or the delivery of specific services or products, without liability for damages resulting from a failure to perform. Project grants include fellowships, scholarships, research grants, training grants, traineeships, experimental and demonstration grants, evaluation grants, planning grants, technical assistance grants, construction grants, and unsolicited contractual agreements.
- *Direct payments for specific use.* Financial assistance is provided by the federal government directly to individuals, private firms, and other private institutions to encourage or subsidize a particular activity by conditioning the receipt of the assistance upon the recipient's performance. These do not include solicited contracts for the procurement of goods and services for the federal government.
- *Direct payments with unrestricted use.* Financial assistance is provided by the federal government directly to beneficiaries who satisfy federal eligibility requirements with no restrictions imposed on how the money is spent. Included are payments under retirement, pension, and compensation programs.
- *Direct loans.* Financial assistance is provided through the lending of federal monies for a specific period of time, with a reasonable expectation of repayment. Such loans may or may not require the payment of interest.
- *Guaranteed insured loans.* For these programs, the federal government makes an arrangement to indemnify a lender against part of any defaults by those responsible for the repayment of loans.
- *Insurance.* Financial assistance is provided to assure reimbursement for losses sustained under specified conditions. Coverage may be provided directly by the federal government or through a private carrier, and may or may not involve the payment of premiums.

- *Sale, exchange, or donation of property and goods.* These programs provide for the sale, exchange, or donation of federal real property, personal property, commodities, and other goods, including land, buildings, equipment, food, and drugs. This does not include the loan of, use of, or access to federal facilities or property.

Federal Cost-Reimbursement Contracts

1.22 The definition of federal awards also includes federal cost-reimbursement contracts. These are contracts with nonfederal entities to provide goods or services to the federal government. These contracts are generally governed by the Federal Acquisition Regulations (found in part 41 of the *Code of Federal Regulations*) and the terms of the contracts.

1.23 Awards may be provided to entities through reimbursement arrangements in which recipients bill grantors for costs as incurred. Some programs provide for advance payments. Other programs permit entities to draw cash as grant expenditures are incurred.

Determining the Scope of a Single Audit

1.24 The scope of the auditor's work in an audit in accordance with Circular A-133 is determined by (a) the level of assessed risk associated with the federal programs and whether they are identified as a major program and (b) the compliance requirements applicable to those programs.

Risk-Based Approach

1.25 The audit scope depends on whether the federal awards expended are identified as relating to major programs. Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides criteria for the auditor to use in applying a risk-based approach. The auditor's determination of the programs to be audited is based on an overall evaluation of the risk of noncompliance occurring which could be material to the individual federal programs. In evaluating risk, the auditor considers, among other things, the current and prior audit experience with the auditee, oversight by the federal agencies and pass-through entities, and the inherent risk of the federal programs. Chapter 7 includes a detailed discussion of applying the risk-based approach to determining major programs.

Compliance Requirements

1.26 Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The term *compliance requirements* refers to the laws, regulations, and provisions of contracts and grant agreements that an auditor should consider in making this determination (see chapter 6 for a more detailed discussion).

1.27 The principal compliance requirements and suggested audit procedures for the largest federal programs are included in the *Compliance Supplement*.¹⁰

¹⁰ The Compliance Supplement is updated on an annual basis. A copy of the most current version of the Compliance Supplement is available for sale from the Government Printing Office by calling (202) 512-1800. It is also available from the OMB's home page at <http://www.whitehouse.gov/omb/grants/>.

1.28 With regard to federal programs included in the *Compliance Supplement*, the auditor should follow the guidance contained in the *Compliance Supplement* for testing compliance requirements. The auditor should be aware that compliance requirements may change over time. Thus, the auditor should also inquire of the auditee and review the provisions of grant agreements to determine whether compliance requirements reflected in the *Compliance Supplement* have changed. If there have been changes, the auditor should follow the provisions of the *Compliance Supplement* as modified by the changes (see chapters 2 and 6 for a more detailed discussion of the *Compliance Supplement*). For programs not listed in the *Compliance Supplement*, the auditor should follow *Compliance Supplement* part 7 “Guidance for Auditing Programs Not Included in This Compliance Supplement,” which instructs the auditor to use the types of compliance requirements (for example, cash management, reporting, allowable costs/cost principles, activities allowed or unallowed, eligibility, and matching, level of effort, and earmarking) contained in the *Compliance Supplement* as guidance for identifying the types of compliance requirements to test, and to determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.

1.29 In addition, some agencies have developed audit guides or supplements related to their programs. Auditors should consult with the applicable federal agency to determine the availability of agency-prepared supplements or audit guides. This guidance, where applicable, may be obtained from the Office of Inspector General of the appropriate federal agency.

The Auditor’s Responsibilities in Single Audits— An Overview

Compliance With Laws and Regulations

1.30 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to provide an opinion on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. The auditor’s responsibility for compliance auditing is discussed further in chapter 6. The required reporting and the schedule of findings and questioned costs are discussed in chapter 10.

Internal Control Over Compliance

Planning

1.31 In a single audit, the auditor must obtain an understanding of the design and operation of internal control over compliance with requirements that could have a direct and material effect on a major program. The auditor’s work in this area is in addition to the consideration of internal control over financial reporting that is part of a financial statement audit. Specifically, the auditor must obtain an understanding of internal control over compliance that is sufficient to plan the audit to support a low assessed level of control risk for major programs.

Testing

1.32 Circular A-133 also requires auditors to test internal control over compliance by implementing the planned tests. Evidence gained from the tests

of controls relevant to compliance requirements may be used by the auditor to determine the nature, timing, and extent of the testing required to express an opinion on compliance with requirements applicable to major programs. The requirements and auditor responsibilities associated with internal control over compliance in a single audit are discussed in chapter 8.

Chapter 2

OVERVIEW OF THE SINGLE AUDIT ACT, CIRCULAR A-133, AND THE OMB CIRCULAR A-133 COMPLIANCE SUPPLEMENT

2.1 This chapter provides an overview of the significant requirements and guidance in the Single Audit Act, Circular A-133, and the *OMB Circular A-133 Compliance Supplement*. Because Circular A-133 incorporates the requirements of the Single Audit Act and provides additional guidance, the requirements of the Act and Circular A-133 are discussed together as one in this SOP. Accordingly, references to Circular A-133 also include the requirements of the Single Audit Act. Auditors should refer to the Single Audit Act, Circular A-133, and the *Compliance Supplement* for a complete understanding of the requirements. The Single Audit Act and Circular A-133 are reprinted in appendixes A and B, respectively. See footnote 10 of chapter 1 for instructions on how to obtain a copy of the *Compliance Supplement*.

Single Audit Act and Circular A-133 Requirements

General Audit Requirements

Audit Threshold

2.2 Entities that expend \$300,000 or more in a fiscal year in federal awards are subject to the Single Audit Act and Circular A-133 and, therefore, must have a single or program-specific audit. Entities expending awards under only one program (excluding research and development [R&D]) may elect to have a program-specific audit if the program's laws, regulations, or grant agreements do not require a financial statement audit. A program-specific audit may not be elected for R&D unless (a) all expenditures are for awards received from the same federal agency or from the same federal agency and the same pass-through entity and (b) advance approval is obtained (see chapter 11 for additional guidance on program-specific audits). Entities that expend less than \$300,000 in a fiscal year in federal awards are exempt from audit requirements in the Single Audit Act and Circular A-133. However, those entities are not exempt from other federal requirements (including those to maintain records) concerning federal awards provided to the entity. Such records must be available for review or audit by appropriate officials of a federal agency, pass-through entity, and the GAO. The Single Audit Act provides that, every two years, the OMB may review the amount for requiring audits and may raise the dollar threshold amount above \$300,000.

Applicable Standards and Covered Entity

2.3 Circular A-133 audits must be conducted by an independent auditor¹ in accordance with *Government Auditing Standards*, and they must cover the entire operations of the auditee or, at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards

¹ The Single Audit Act defines "independent auditor" as (a) an external state or local government auditor who meets the independence standards included in *Government Auditing Standards* or (b) a public accountant who meets such independence standards.

during the fiscal year, provided that each audit encompasses the financial statements and the schedule of expenditures of federal awards for each such department, agency, and organizational unit (see paragraph 3.27 for a more detailed discussion of this requirement).

Relation to Other Audit Requirements

2.4 A Circular A-133 audit is deemed to be in lieu of any financial audit of federal awards that an entity is required to undergo under any other federal law or regulation. However, notwithstanding a Circular A-133 audit, a federal agency (including its Inspectors General or GAO) may conduct or arrange for additional audits (for example, financial audits, performance audits, evaluations, inspections, or reviews) that are necessary to carry out their responsibilities under federal law or regulation. Any additional audits should be planned and performed in such a way as to build upon work performed by auditors. A federal agency that conducts or contracts for additional audits must arrange for funding the full cost of such additional audits. See paragraph 2.19 for a discussion of the federal agency option to request certain programs to be audited as major programs.

Frequency of Audits

2.5 Circular A-133 audits must be performed annually unless an auditee meets one of the following criteria that would allow it to have biennial audits (biennial audits should cover both years within the biennial period):

- State or local governments that are required by constitution or statute (in effect on January 1, 1987) to undergo audits less frequently than annually are permitted to have Circular A-133 audits performed biennially. This requirement must still be in effect for the biennial period under audit.
- NPOs that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, are permitted to have Circular A-133 audits performed biennially.

Non-U.S.-Based Entities

2.6 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient. For example, if a federal agency provides financial assistance to an orphanage operated by a foreign government, Circular A-133 would not apply. However, the circular does apply to expenditures made by U.S.-based entities outside of the United States and by foreign branches of U.S.-based entities. For example, if a university based in the United States receives a federal award for travel and a three-month residence in a foreign country to conduct research, Circular A-133 would apply to the travel and the related research costs incurred in the foreign country. Another example would be a hospital that receives a federal award to perform medical research in a foreign country. If the research is conducted in the hospital's research laboratory based in the foreign country, the federal award would be subject to an audit under Circular A-133.

Audit Objectives and Reporting Matters

Audit Objectives

2.7 In a single audit, the auditor's objectives are to—

- Determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally

accepted accounting principles. (Note that Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. See paragraphs 4.2 and 4.3 for a further discussion.)

- Determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.
- Obtain an understanding of the internal control over compliance for each major program, assess the control risk, and perform tests of those controls unless the controls are deemed to be ineffective (the auditor must perform procedures to obtain an understanding of internal control over federal programs that is sufficient to plan the audit to support a low assessed level of control risk for each major program).
- Determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements pertaining to federal awards that may have a direct and material effect on each of its major programs.

Audit Reports

2.8 Section 505 of Circular A-133 includes specific auditor reporting requirements. Those requirements are summarized in paragraph 10.3. See paragraphs 10.8 through 10.10 for a description of the reports illustrated in this SOP to meet the reporting requirements of Circular A-133.

Timing of the Submission of the Report

2.9 The audit should be completed and the data collection form and the reporting package (described in paragraphs 2.24, 2.25, 10.6, and 10.7), including the auditor's reports, should be submitted by the auditee (to the federal clearinghouse designated by the OMB) within the earlier of thirty days after receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit (see paragraphs 10.74 through 10.79 for a further discussion).^[2]

Audit Follow-Up

2.10 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 3.26 and 6.61 through 6.67 for a further discussion of the auditor's responsibility for audit follow-up.)

Auditor Selection and Audit Costs

Procurement of Audit Services and Restriction on Auditors Who Prepare Indirect Cost Proposals

2.11 Circular A-133 also establishes guidance on the procurement of audit services, as well as guidance on the restrictions on the selection of auditors

^[2] [Deleted.]

who also prepare the indirect cost proposal or cost allocation plan. Auditors who prepare the indirect cost proposal or cost allocation plan may not also be selected to perform the Circular A-133 audit if the indirect costs recovered by the auditee during the prior year exceeded \$1 million.^[3] See paragraph 3.54 for additional information on this restriction.

Audit Costs

2.12 Circular A-133 provides guidance on whether the charging of audit costs to federal awards may be allowed. Unless prohibited by law, the costs of Circular A-133 audits are allowable charges to federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB Cost Principles Circulars, the Federal Acquisition Regulation, or other applicable cost principles or regulations. The costs of single audits that are not conducted in accordance with Circular A-133 are unallowable. Furthermore, audit costs associated with Circular A-133 audits of entities that expend less than \$300,000 per year in federal awards are unallowable. However, this provision does not prohibit pass-through entities from charging federal awards for the costs of limited-scope audits to monitor its subrecipients. See paragraph 9.32 for further information on the allowability of audit costs associated with limited-scope audits. With regard to the amount of audit cost that can be charged to a federal award, the Single Audit Act states that in the absence of documentation demonstrating a higher actual cost, the percentage of the cost of single audits charged to federal awards by an entity may not exceed the ratio of total federal awards expended to the entity's total expenditures for the fiscal year.

Basis for Determining When Federal Awards Are Expended

2.13 The determination of when an award is expended is based on when the activity related to the award occurs. In general, the activity pertains to events that require the auditee to comply with laws, regulations, and the provisions of contracts or grant agreements. Such events include the following:

- Expenditure/expense transactions associated with grants, cost reimbursement contracts, cooperative agreements, and direct appropriations
- The disbursement of funds passed through to subrecipients
- The use of loan proceeds under loan and loan-guarantee programs
- The receipt of property
- The receipt of surplus property
- The receipt or use of program income
- The distribution or consumption of food commodities
- The disbursement of amounts entitling the auditee to an interest subsidy
- The period when insurance is in force

2.14 Circular A-133 provides specific guidance on the basis of determining federal awards expended for the following noncash items (see paragraphs 5.13 through 5.15 for additional discussion):

^[3] [Deleted.]

- Loans and loan guarantees, including those at institutions of higher education
- Prior loans and loan guarantees
- Endowment funds
- Free rent
- Noncash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property
- Medicare payments to a nonfederal entity for providing patient care services
- Medicaid payments to a subrecipient for providing patient care services

Subrecipient and Vendor Determinations

2.15 An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient are subject to audit under Circular A-133. The payments received for goods or services provided as a vendor would not be considered federal awards. Circular A-133 provides specific guidance on determining whether payments constitute a federal award or a payment for goods and services. This guidance is discussed further in chapter 9.

Major Program Determination

Risk-Based Approach

2.16 Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. The risk-based approach includes consideration of current and prior audit experience, oversight by federal agencies and pass-through entities, and the inherent risk of the federal programs. This risk-based approach and the determination of major programs are discussed in chapter 7.

Low-Risk Auditee

2.17 Circular A-133 contains certain criteria for considering an auditee to be a low-risk auditee. A low risk-auditee is eligible for reduced audit coverage. It should be noted that *low-risk auditee* is a term defined in Circular A-133 for the purpose of applying the percentage-of-coverage rule (see paragraphs 7.24 and 7.25) in the risk-based approach. It does not imply or require the auditor to assess audit risk or any of its components as low for an entity that meets the Circular A-133 definition of a low-risk auditee.

Cluster of Programs

2.18 OMB Circular A-133 defines a cluster of programs as a grouping of closely related federal programs that share common compliance requirements. The types of clusters of programs are R&D, student financial aid (SFA), and other clusters. “Other clusters” are defined by the OMB in the *Compliance Supplement* or are designated as such by a state for the federal awards the state provides to its subrecipients that meet the definition of a cluster of programs. When a state designates federal awards as an “other cluster,” it must also identify the federal awards included in the cluster and advise the

subrecipients of the compliance requirements applicable to the cluster. A cluster of programs should be considered as one program for determining major programs and (with the exception of R&D), whether a program-specific audit may be elected.

Federal Agency Selection of Additional Major Programs

2.19 A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. After consultation with its auditor, the auditee should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach (described in chapter 7) and, if not, the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon the federal agency request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

Auditee Responsibilities

Preparation of Appropriate Financial Statements

2.20 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, the results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits in accordance with Circular A-133 and prepare separate financial statements (see paragraph 3.27 for a further discussion). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

Summary Schedule of Prior Audit Findings

2.21 The auditee is also required to prepare a summary schedule of prior audit findings. The schedule should report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to federal awards. It should also include audit findings reported in the prior audit's summary schedule of prior audit findings, except audit findings that have been corrected or are no longer valid. See paragraphs 10.68 through 10.70 for a further discussion of this schedule.

Other Responsibilities

2.22 In addition to the responsibilities described in paragraphs 2.20 and 2.21, Circular A-133 establishes certain other responsibilities for auditees, including the following:

- Identifying in its accounts all federal awards received and expended and the federal programs under which they were received, including, as applicable, the CFDA title and number, the award number and

year, the name of the federal agency, and the name of the pass-through entity

- Establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs
- Complying with laws, regulations, and the provisions of contract or grants agreements related to each of its federal programs
- Ensuring that the audits required by Circular A-133 are properly performed and submitted when due
- Following up and taking corrective action on audit findings (including the preparation of a summary schedule of prior audit findings (see paragraph 2.21) and a corrective action plan (see paragraph 2.26); corrective action should be initiated within six months after the receipt of the audit report and proceed as rapidly as possible

Responsibility for Compliance at the Financial Statement Level and for Internal Control Over Financial Reporting

2.23 Although not specifically stated in Circular A-133, the auditee is also responsible for complying with the requirements of laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on the financial statements and for establishing and maintaining effective internal control over financial reporting. These responsibilities support the requirements of *Government Auditing Standards*.

Reporting Package

2.24 The auditee is also required to submit a reporting package that includes financial statements and a schedule of expenditures of federal awards (see paragraph 2.20 and chapters 4 and 5), the summary schedule of prior audit findings (see paragraph 2.21), the auditor's reports (see paragraph 2.8), and a corrective action plan (see paragraph 2.26). Although not part of the reporting package, the submission of the report must also include the data collection form described in paragraph 2.25. The report submission requirements of Circular A-133 are described in paragraphs 2.9 and 10.74 through 10.79. Auditees must keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse. Furthermore, unless restricted by law or regulation, the auditee is required to make copies of the data collection form and the reporting package available for public inspection.

Data Collection Form

2.25 The auditee is required to complete and sign certain sections of a data collection form which states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. The auditor is also required to complete and sign certain sections of this form. See paragraphs 10.71 through 10.73 for a further discussion of the data collection form.

Corrective Action Plan

2.26 At the completion of the audit, the auditee should prepare a corrective action plan to address each audit finding included in the current year's

auditor's reports. See paragraphs 10.68 through 10.70 for a further discussion of the corrective action plan.

Federal Awarding Agency Responsibilities

2.27 For federal agencies that provide federal awards to recipients, Circular A-133 establishes certain responsibilities including the following:

- Identifying the federal awards made by informing each recipient of the CFDA title and number, the award name and number, the award year, and if the award is for R&D. When some of this information is not available, the federal agency must provide information necessary to clearly describe the federal award
- Advising recipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements
- Ensuring that audits are completed and reports are received in a timely manner and in accordance with the requirements of Circular A-133
- Providing technical advice and counsel to auditees and auditors as requested
- Issuing a management decision on audit findings within six months after receipt of the audit report and ensuring that the recipient takes appropriate and timely corrective action
- Assigning a person to provide annual updates of the *Compliance Supplement* to the OMB

Pass-Through Entity Responsibilities

2.28 Pass-through entities have many responsibilities that are similar to those of federal awarding agencies. See chapter 9 for a detailed description of the responsibilities of pass-through entities.

Cognizant Agency for Audit

Definition

2.29 Circular A-133 defines the cognizant agency for audit as a federal agency designated to carry out the federal responsibilities with regard to a single audit. For recipients expending more than \$25 million a year in federal awards, the cognizant agency for audit will be the federal awarding agency that provides the predominant amount of direct funding to the recipient unless the OMB makes a specific cognizant agency for audit assignment. The determination of the predominant amount of direct funding is based on the direct federal awards expended by a recipient during its fiscal year ending in 1995, 2000, 2005, and every fifth year thereafter. For example, the audit cognizance for periods ending in 1997 through 2000 will be determined based on the federal awards expended in 1995.⁴ Audit cognizance can be reassigned if both the old and the new federal agencies notify the auditee (and, if known, the auditor), of

⁴ It should be noted that for states and local governments that expend more than \$25 million a year in federal awards and have previously assigned cognizant agencies for audit, the requirements in this paragraph are not effective until fiscal years beginning after June 30, 2000.

the change within thirty days of the reassignment. A recipient may have one federal agency responsible for audit cognizance and another federal agency responsible for the negotiation of indirect costs.

Responsibilities

2.30 Circular A-133 states that a cognizant agency for audit is responsible for—

- Providing technical audit advice and liaison to auditees and auditors.
- Considering auditee requests for extensions to the report submission due date. The cognizant agency for audit may grant extensions for good cause.
- Obtaining or conducting quality control reviews of selected audits made by nonfederal auditors and providing the results, when appropriate, to other interested organizations.
- Promptly informing other affected federal agencies and appropriate federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by *Government Auditing Standards* or laws and regulations.
- Advising the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee should work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit must notify the auditor, the auditee, and the applicable federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repeated substandard performance by auditors will be referred to appropriate state licensing agencies and professional bodies for disciplinary action.
- Coordinating, to the extent practicable, the audits or reviews made by or for federal agencies that are in addition to audits under Circular A-133, so that the additional audits or reviews build upon the Circular A-133 audits performed.
- Coordinating a management decision for audit findings that affect the federal programs of more than one federal agency.
- Coordinating the audit work and reporting responsibilities among auditors, to achieve the most cost-effective audit.

For biennial audits, the cognizant agency for audit is also responsible for considering auditee requests to qualify as a low-risk auditee.

Oversight Agency for Audit

Definition

2.31 An auditee that does not have a designated cognizant agency for audit that (that is, one that expends \$25 million or less in federal awards) will have an oversight agency for audit. Circular A-133 defines the oversight agency for audit as a federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit (see paragraphs 2.29 and 2.30). When there is no direct funding, the federal agency

with the predominant indirect funding is required to assume the oversight responsibilities.

Responsibilities

2.32 Circular A-133 describes the duties of oversight agencies for audit. The responsibilities of an oversight agency for audit are not as broad as those of a cognizant agency for audit. However, an oversight agency's primary responsibility is to provide technical advice to auditees and auditors when it is requested. An oversight agency may assume all or some of the responsibilities normally performed by a cognizant agency for audit.

Program-Specific Audits

2.33 Circular A-133 provides general guidance on performing program-specific audits. In many cases, a program-specific audit guide will be available from the federal agency's Office of Inspector General. The audit guide will provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. When a program-specific audit guide is not available, the auditee and auditor have basically the same responsibilities for the federal program as they would have for an audit of a major program in a single audit. Program-specific audits are discussed further in chapter 11.

OMB Circular A-133 Compliance Supplement

2.34 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits. The *Compliance Supplement* serves to identify existing compliance requirements that the federal government expects to be considered as part of an audit in accordance with the Single Audit Act and Circular A-133. For the programs included in the *Compliance Supplement*, it 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 the audit objectives and suggested audit procedures for determining compliance with these requirements. It also provides guidance to assist auditors in determining compliance requirements relevant to the audit, audit objectives, and suggested audit procedures for programs not included in the *Compliance Supplement*. For single audits, the *Compliance Supplement* replaces agency audit guides and other audit requirement documents for individual federal programs.

2.35 The *Compliance Supplement*, which is updated on an annual basis, is discussed in greater detail in paragraphs 1.27, 1.28, and 6.21 through 6.30.

Chapter 3

PLANNING AND OTHER SPECIAL AUDIT CONSIDERATIONS OF CIRCULAR A-133

3.1 In planning an audit to meet the requirements of Circular A-133, the auditor needs to consider several matters in addition to those ordinarily associated with an audit of financial statements in accordance with GAAS and *Government Auditing Standards*.¹ In this chapter the overall planning considerations in a single audit conducted in accordance with Circular A-133 are discussed. Many of these planning considerations are also applicable in a program-specific audit. Program-specific audits are discussed in detail in chapter 11.

3.2 The following matters are relevant to the planning of a single audit:

- Satisfying Circular A-133 requirements and other relevant legal, regulatory, or contractual requirements (see paragraphs 3.3 through 3.5)
- Establishing an understanding with the auditee (see paragraphs 3.6 and 3.7)
- Satisfying the additional requirements of *Government Auditing Standards* (see paragraphs 3.8 through 3.26)
- Satisfying the additional requirements of the Single Audit Act and Circular A-133 regarding working papers and audit follow-up (see paragraphs 3.27 through 3.29)
- Defining the entity to be audited (see paragraph 3.30)
- Determining the audit period (see paragraphs 3.31 and 3.32)
- Initial-year audit considerations (see paragraphs 3.33 and 3.34)
- The timing of the completion of the audit and reporting submission deadlines (see paragraph 3.35)
- Determining the major programs to be audited (see paragraph 3.37)
- The preliminary assessment of audit risk (see paragraph 3.39)
- Audit materiality considerations (see paragraphs 3.40 through 3.47)
- Determining compliance requirements (see paragraph 3.48)
- Developing an efficient audit approach (see paragraph 3.49)
- Joint audits and reliance on others (see paragraphs 3.50 through 3.54)
- Existence of internal audit function (see paragraph 3.55)
- Communications with the cognizant agency for audit and others (see paragraph 3.56)
- Understanding the applicable state and local compliance and reporting requirements (see paragraphs 3.57 through 3.59)
- Desk reviews and on-site reviews (see paragraphs 3.60 and 3.61)

¹ In AICPA *Professional Standards*, AU section 311, "Planning and Supervision," the auditor's responsibilities for planning and supervision in an audit of financial statements in accordance with GAAS are described. Paragraphs 4.6 through 4.11 of *Government Auditing Standards* describe its planning requirements.

- The restriction on the auditor's preparation of indirect cost proposals (see paragraph 3.62)
- The exit conference (see paragraphs 3.63 and 3.64)

Satisfying Circular A-133 Requirements and Other Relevant Legal, Regulatory, or Contractual Requirements

3.3 Because of the variety of audit requirements to which entities receiving federal awards are subject, paragraph 21 of SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance* (AICPA, *Professional Standards*, vol. 1, AU sec. 801.21), states that auditors should exercise due professional care in ensuring that they and management understand the type of engagement to be performed. The auditor should consider including a statement about the type of engagement and whether it is intended to meet specific audit requirements in a proposal, in a contract, or in the communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7 for a further discussion of the establishment of an understanding with the auditee).

3.4 Management is also responsible for obtaining audits that satisfy relevant legal, regulatory, or contractual requirements. Paragraph 22 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.22) states that GAAS do not require the auditor to perform procedures beyond those he or she considers necessary to obtain sufficient competent evidential matter to form a basis for the opinion on the financial statements. However, 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 the audit committee, or to others with equivalent authority and responsibility, that an audit in accordance with GAAS may not satisfy the relevant legal, regulatory, or contractual requirements.² For example, the auditor will be required to make this communication if he or she is engaged to perform an audit of an entity's financial statements in accordance with GAAS and the auditor becomes aware that by law, regulation, or contractual agreement, the entity is also required to have an audit performed in accordance with one or more of the following:

- *Government Auditing Standards*
- The Single Audit Act and Circular A-133
- Other compliance audit requirements, such as state or local laws or program-specific audits under federal audit guides

3.5 Paragraph 23 of SAS No. 74 (AICPA, *Professional Standards*, vol. 1, AU sec. 801.23) states that the required communication may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. The auditor should consider how the client's actions in response to such a communication relate to other aspects of the audit, including their potential effect on the financial statements and on the auditor's report on those financial statements. Specifically, the auditor should consider management's actions (such as not arranging for an audit that meets the applicable requirements) in relation to the guidance in SAS No. 54, *Illegal Acts by Clients*, and SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*.

² For entities that do not have audit committees, "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, the owner in owner-managed entities, the city council, or the legislative standing committee.

Establishing an Understanding With the Auditee

3.6 SAS No. 83, *Establishing an Understanding With the Client* (AICPA, *Professional Standards*, vol. 1, AU sec. 310),* states that the auditor should establish an understanding with the auditee regarding the services to be performed. Such understanding reduces the risk that either the auditor or the auditee may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the auditor's responsibilities, and the limitations of the engagement. The auditor should document this understanding in the working papers, preferably through a written communication with the auditee. If the auditor believes an understanding with the client has not been established, he or she should decline to accept the engagement.

3.7 SAS No. 83 includes a listing of the matters that should generally be included when the auditor establishes an understanding with the auditee regarding an audit of the financial statements. In addition to those matters, the auditor should also consider including the following information in the communication when he or she is engaged to perform a single audit:

- A description of the financial statements and supplemental schedule(s) to be audited
- The reporting period
- The auditing standards and requirements that will be followed (for example, GAAS, *Government Auditing Standards*, and Circular A-133)
- The objective of an audit in accordance with Circular A-133
- A description of the reports the auditor is expected to prepare and issue, including any limitation on their use
- A description of management's responsibility for (a) the financial statements and the schedule of expenditures of federal awards; (b) internal control over financial reporting and internal control over compliance; (c) compliance with laws, regulations, and the provisions of contracts and grant agreements; (d) following up and taking corrective action on audit findings, including the preparation of a summary schedule of prior audit findings and a corrective action plan; and (e) submitting the reporting package
- A statement that management has made the auditor aware of significant vendor relationships where the vendor is responsible for program compliance (so that the auditor can determine if additional procedures on vendor records will be necessary—see paragraphs 9.16 and 9.17)
- A description of the auditor's responsibility in an audit of financial statements and in a compliance audit of major programs under Circular A-133, including the determination of major programs, the consideration of internal control, and reporting responsibilities

* In December 1999, the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which, among other matters, amends SAS No. 83 to include in the understanding with the client, management's responsibility for determining the appropriate disposition of financial statement misstatements aggregated by the auditor. SAS No. 89 adds to the list of matters that are generally included in the understanding with the client a statement that 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. SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999, with early adoption permitted.

- Other communications that may arise from the audit
- A description of the working paper retention requirements
- A statement that the working papers will be made available upon request to appropriate federal agencies and the GAO
- The communication with the organization or entity being audited (the auditee), the individuals contracting for or requesting audit services, and the audit committee required by *Government Auditing Standards* (see paragraphs 3.14 and 3.15 for a further discussion of this requirement)

SAS No. 83 also states that the establishment of an understanding may be communicated in the form of an engagement letter.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Satisfying the Additional Requirements of *Government Auditing Standards*

3.8 Circular A-133 requires that audits of the financial statements and of the federal awards of the auditee be performed in accordance with *Government Auditing Standards* (see chapter 4 for a further discussion). In an audit in accordance with *Government Auditing Standards*, the auditor has considerations beyond those in a GAAS audit. *Government Auditing Standards* incorporates the fieldwork and reporting standards of GAAS and has general standards (described in chapter 2 of *Government Auditing Standards*) that are similar to those of the AICPA (that is, auditor qualifications, independence, and due professional care). However, *Government Auditing Standards* also contains additional general, fieldwork, and reporting requirements, which are summarized in Table 3.1 and discussed in detail in the three subsequent sections of this chapter.

Table 3.1

Additional Financial Statement Audit Requirements of *Government Auditing Standards*

General Requirements

- Continuing professional education (CPE) in subjects directly related to the government environment and to government auditing or to the specific or unique environment that the audited entity operates in
- Appropriate internal quality control system and external quality control review every three years

Fieldwork Requirements

- Communication with the organization or entity being audited (the auditee), the individuals contracting for or requesting audit services, and the audit committee
- Audit follow-up requirements on known material findings and recommendations from previous audits
- Plan audit to provide reasonable assurance of detecting misstatements resulting from noncompliance with provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts
- Documentation requirements when assessing control risk at maximum for controls significantly dependent upon computerized information systems
- Additional working paper requirements

Reporting Requirements

- Referring to *Government Auditing Standards* in the auditor's report
 - Reporting on compliance with laws and regulations and on internal control over financial reporting
 - Consideration of privileged and confidential information
 - Report distribution
-

3.9 *Government Auditing Standards* also provides additional guidance on audit materiality, on fraud^[3] and illegal acts, and on internal controls. Table 3.2 summarizes where this additional guidance is provided in *Government Auditing Standards* and also where it is discussed in this SOP.

Table 3.2

Additional Guidance in *Government Auditing Standards*

<i>Area of Additional Guidance</i>	<i>Government Auditing Standards Reference</i>	<i>SOP Reference</i>
Materiality	Paragraphs 4.6.1 and 4.6.2	Paragraph 3.44
Fraud and illegal acts	Paragraphs 4.14 through 4.17	Paragraphs 10.21 through 10.25
Internal controls	Paragraphs 4.21 through 4.30	Paragraphs 4.17 and 4.18

General Requirements

Continuing Professional Education

3.10 *Government Auditing Standards* requires auditors to participate in a program of continuing professional education (CPE) and training. Every two years, all auditors (whether certified or not) performing audits in accordance with *Government Auditing Standards* should complete at least eighty credit hours of training that contribute directly to their professional proficiency. At least twenty of those hours should be completed in each year of the two-year period. For auditors responsible for planning, directing, or reporting on the audit and for auditors conducting substantial portions of the audit, at least twenty-four hours should be in subjects directly related to the government environment and to government auditing. If the auditee operates in a specific or unique environment, auditors should receive training that is related to that environment. For example, if the auditor performs an audit of a not-for-profit organization, the twenty-four hours should be in topics related to the not-for-profit accounting and auditing environment. These could include compliance and government-related courses or those broadly related to the type of not-for-profit organization being audited.

3.11 *Interpretation of Continuing Education and Training Requirements*, a detailed interpretation of the foregoing CPE standards, is available from the GAO’s home page at <http://www.gao.gov/govaud/ybk01.htm>. Among other things, this interpretation discusses who is subject to the CPE requirements and what programs, activities, and subjects qualify as acceptable CPE. During engagement planning, auditors and audit organizations should ensure that members of the audit team have met or will meet the appropriate CPE requirements within two years of the start of the first audit in accordance with *Government Auditing Standards*, and every two years thereafter.

Quality Control

3.12 *Government Auditing Standards* also states that the audit organization should have in place an appropriate internal quality control system and undergo an external quality control review (for example, a peer review). An external quality control review should be conducted at least once every three years by an organization not affiliated with the organization being reviewed.

[3] [Deleted.]

3.13 *Government Auditing Standards* further requires audit organizations seeking to enter into a contract to perform an audit in accordance with *Government Auditing Standards* to provide their most recent external quality control review report to the party contracting for the audit. Auditors are not required to provide separate letters of comment. Auditors should consider documenting in the working papers the provision of the quality control review report to the party contracting for the audit.

Fieldwork Requirements

Auditor Communication

3.14 *Government Auditing Standards* requires the auditor to communicate the following information to the parties identified in paragraph 3.15 during the planning stages of an audit:

- The auditor's responsibilities in a financial statement audit, including their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting.
- The nature of any additional testing of compliance and internal control required by laws and regulations or otherwise requested, and whether the auditor is planning on providing opinions on compliance with laws and regulations and internal control over financial reporting.

To assist in communicating the limitations of the auditor's responsibilities for compliance and internal control over financial reporting, the auditor may also want to contrast those responsibilities with other financial related audits of compliance and controls. The discussion in paragraphs 4.6.8 and 4.6.9 of *Government Auditing Standards* may be helpful to auditors in explaining their responsibilities for testing and reporting on compliance with laws and regulations and internal control over financial reporting. Auditors should use professional judgment in determining the form and content of the communication, although written communication is preferred. An engagement letter may be used to make the communication (see paragraphs 3.6 and 3.7). Auditors should document the communication in the working papers.

3.15 The auditor should communicate the information in paragraph 3.14 to the following:

- Appropriate officials of the organization or entity being audited (the auditee) which would normally include the head of the organization, the audit committee or board of directors or other equivalent oversight body in the absence of an audit committee, and the individual who possesses a sufficient level of authority such as the chief financial officer
- In situations where the auditor is performing the audit under a contract with a party other than the auditee, or pursuant to a third-party request, the auditor should also communicate with the individuals contracting for or requesting the audit services; and
- When the auditor is performing the audit pursuant to a law or regulation, the auditor should communicate with the legislative members or staff who have oversight of the auditee. **(This requirement applies only to situations where the law or regulation specifically identifies the entity to be audited. Situations where the financial statement audit mandate applies to entities not specifically identified, such as audits required by the Single Audit Act Amendments of 1996, are excluded.)**

Audit Follow-Up

3.16 *Government Auditing Standards* states that the auditee is responsible for resolving audit findings and recommendations. It further requires auditors to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit. The purpose of this follow-up is to determine whether the auditee has taken timely and appropriate corrective actions. *Government Auditing Standards* also requires auditors to report the status of uncorrected material findings and recommendations that are from prior audits and that affect the financial statement audit. (See paragraphs 3.26, 6.61 through 6.67, and 10.62 for a further discussion of the auditor's responsibility for audit follow-up under both *Government Auditing Standards* and Circular A-133 and how these responsibilities correlate.)

Responsibilities With Regard to the Provisions of Contracts and Grant Agreements

3.17 Paragraph 4.13 of *Government Auditing Standards* refers to additional responsibilities with regard to detecting material misstatements resulting from noncompliance with the provisions of contract and grant agreements that have a direct and material effect on the determination of financial statement amounts. However, it has generally been interpreted under GAAS that the phrase *laws and regulations* in SAS No. 54 implicitly includes the provisions of contracts and grant agreements. Thus, the auditor's responsibility with regard to detecting material misstatements resulting from noncompliance with the provisions of contracts and grant agreements under *Government Auditing Standards* equates to the auditor's responsibility under GAAS.

Internal Control Documentation Requirement

3.18 Paragraphs 4.21.3 and 4.21.4 of *Government Auditing Standards* include an additional internal control standard that requires auditors, when planning the audit, to document the following in the working papers (see also paragraphs 3.20 through 3.22 for a further discussion of the additional *Government Auditing Standards* requirements for working papers):

- The basis for assessing control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems; and
- Consideration that the planned audit procedures are designed to achieve audit objectives and to reduce audit risk to an acceptable level.

3.19 This additional standard does not increase the auditor's responsibility for testing controls. However, it may require additional documentation. If the auditor assesses control risk at the maximum level for assertions related to material account balances, transaction classes, and disclosure components of financial statements when such assertions are significantly dependent upon computerized information systems, the auditor should document in the working papers the basis for that conclusion by addressing (1) the ineffectiveness of the design and/or operation of the controls, or (2) the reasons why it would be inefficient to test the controls. In such circumstances, *Government Auditing Standards* also requires the auditor to document in the working papers the consideration that the planned audit procedures are designed to achieve specific audit objectives and, accordingly, to reduce audit risk to an acceptable level. This documentation should address:

- The rationale for determining the nature, timing, and extent of planned audit procedures;

- The kinds and competence of available evidential matter produced outside a computerized information system; and
- The effect on the audit opinion or report if evidential matter to be gathered during the audit does not afford a reasonable basis for the auditor's opinion on the financial statements.

Working Papers

3.20 SAS No. 41, *Working Papers* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), provides guidance on the auditor's preparation and maintenance of working papers. *Government Auditing Standards* includes an additional standard that requires working papers to contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments. This additional standard requires working papers to include sufficient documentation of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records. *Government Auditing Standards* also states that auditors should provide for working paper access to other auditors, to facilitate reviews of audit quality and reliance by other auditors on the auditor's work, and should provide for such access in contractual arrangements for *Government Auditing Standards* audits (see paragraphs 3.24 and 3.25 for a discussion of the working paper access and retention requirements under Circular A-133).

3.21 Audits done in accordance with *Government Auditing Standards* are subject to review by other auditors and by oversight officials more frequently than are audits done in accordance with GAAS. Thus, whereas GAAS cites two main purposes of working papers (providing the principal support for the audit report and aiding auditors in the conduct and supervision of the audit), working papers serve an additional purpose in audits performed in accordance with *Government Auditing Standards*. Working papers allow for the review of audit quality by providing the reviewer written documentation of the evidence supporting the auditor's significant conclusions and judgments.

3.22 *Government Auditing Standards* specifically states that working papers should contain—

- The objectives, scope, and methodology, including any sampling criteria used.
- Documentation of the work performed to support significant conclusions and judgments, including descriptions of the transactions and records examined that would enable an experienced auditor to examine the same transactions and records.⁴
- Evidence of supervisory reviews of the work performed.

Reporting Requirements

3.23 The additional reporting requirements of *Government Auditing Standards*—referring to *Government Auditing Standards* in the auditor's report, reporting on compliance with laws and regulations and on internal control over financial reporting, consideration of privileged and confidential information, and report distribution—are addressed in paragraphs 10.15 and 10.16.

⁴ Auditors may meet this requirement by listing voucher numbers, check numbers, or other means of identifying specific documents they examined. Auditors are not required to include in the working papers copies of documents they examined nor are they required to list detailed information from those documents.

Communication With Audit Committees or Other Responsible Individuals

3.24 *Government Auditing Standards* includes an additional reporting standard that requires the auditor to communicate certain information related to the conduct and reporting of the audit to the audit committee or to the individuals with whom they have contracted for the audit. This standard applies in all situations in which there is an audit committee or the audit is performed under contract. In other situations, the auditor may still find it useful to communicate with management or other officials of the auditee, although it is not required. The auditor should communicate the following information to the audit committee or representatives of the contractor:

- a. The auditor's responsibilities in a financial statement audit, including his or her responsibilities for testing and reporting on internal control and compliance with laws and regulations
- b. The nature of any additional testing of internal controls and compliance required by laws and regulations
- c. The responsibilities and the nature of any additional testing described in items *a* and *b* should be contrasted with other financial related audits of internal control and compliance (to help responsible parties understand the limitations of the auditor's responsibilities for testing and reporting on internal control and compliance)

3.25 Professional judgment should be used in determining the form and content of the communication, which may be oral or written. If the communication is oral, the auditor should document the communication in the working papers. If written, the required communication may be issued as a separate communication or as part of the auditor's communication issued to establish an understanding with the auditee (see paragraphs 3.6 and 3.7).

Other Additional Reporting Requirements

3.26 The other additional reporting requirements of *Government Auditing Standards*—referring to *Government Auditing Standards* in the auditor's report, reporting on compliance with laws and regulations and on internal control, consideration of privileged and confidential information, and report distribution—are addressed in paragraphs 10.15 and 10.16.

Satisfying the Additional Requirements of the Single Audit Act and Circular A-133 Regarding Working Papers and Audit Follow-Up**Working Papers**

3.27 The Single Audit Act states that upon request by a federal agency or the Comptroller General, any independent auditor conducting a single audit should make the auditor's working papers available to the federal agency or the Comptroller General (*a*) as part of a quality review, (*b*) to resolve audit findings, or (*c*) to carry out oversight responsibilities. It also states that access to the auditor's working papers shall include the right to obtain copies. The Single Audit Act intends that federal agencies be judicious in the exercise of this authority and that the release of the working papers should not compromise the confidentiality of proprietary information. The Single Audit Act also intends that any trade secrets and confidential commercial or financial information obtained from the working papers be treated as confidential under the

Freedom of Information Act. Auditors should refer to the guidance in the AICPA Auditing Interpretation titled *Providing Access to or Photocopies of Working Papers to a Regulator* (AICPA, *Professional Standards*, vol. 1, AU sec. 9339), when a regulator requests access to the auditor's working papers pursuant to law, regulation, or audit contract.

3.28 Circular A-133 requires that auditors retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor is required to contact the parties contesting the audit finding for guidance prior to the destruction of the working papers and reports.

Audit Follow-Up

3.29 In addition to the requirements of *Government Auditing Standards*, Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. (See paragraphs 6.61 through 6.67 and 10.62 for a further discussion of the responsibility for audit follow-up under both Circular A-133 and *Government Auditing Standards* and how these responsibilities correlate.)

Defining the Entity to Be Audited

3.30 One of the initial tasks during the planning process of a single audit is determining whether management has properly defined the entity to be audited. Circular A-133 requires that single audits must cover the entire operations of the auditee. However, Circular A-133 provides auditees the option to meet the audit requirements of the circular through a series of audits that cover an auditee's departments, agencies, and other organizational units which expended or otherwise administered federal awards during a fiscal year. If an auditee elects this option, then separate financial statements and a schedule of expenditures of federal awards must be prepared for each such department, agency, or other organizational unit. In these circumstances, an auditee's organization-wide financial statements may also include departments, agencies, or other organizational units that have separate audits and prepare separate financial statements. For example, if a local government has its school districts audited separately, it would be acceptable for the local government's financial statements to include the school districts, even though the school districts were not included in the local government's Circular A-133 audit, because a separate Circular A-133 audit was conducted of the school districts. However, if separate financial statements were not prepared for the school districts, it would be unacceptable for a separate Circular A-133 audit to be conducted of the school districts (that is, the local government's organization-wide financial statements could not be used as a substitute for separate financial statements for the school districts). See paragraph 10.34 for a discussion of the situation where the implementation regulations of certain federal agencies define the entity to be audited differently than GAAP.

Determining the Audit Period

Fiscal Year and Program Period May Differ

3.31 An audit performed in accordance with Circular A-133 should cover the auditee's financial transactions (including transactions related to federal awards) for its fiscal year (or a two-year period, if allowed by Circular A-133), which is not necessarily the same as the period of the program being funded (see paragraph 2.5 for further information on biennial audits). Thus, the audit might include only a part of the transactions of a federal award, because some transactions may not occur within the period covered by the audit.

Stub Periods

3.32 Stub periods may occur when an auditee converts from a program-specific audit to a single audit or changes audit periods. One example would be a community college with a September 30 year end that previously had a program-specific audit and is now converting to a single audit. The prior program-specific audits were performed based on a June 30 award year. The first single audit will be for the year ending September 30. This would leave the community college with an unaudited stub period of June 30 to September 30. Arrangements should be made to meet the audit requirements for federal expenditures during the stub period. This is usually done either as a separate audit of the stub period or by including expenditures of the stub period with the following period's Circular A-133 audit. The cognizant or oversight agency for audit or the pass-through entity should be contacted for advice on how stub periods should be addressed.

Initial-Year Audit Considerations

Preceding Period Audited by Another Auditor

3.33 Whenever an auditor is considering accepting an engagement in which the federal awards of the preceding period were audited by another auditor, he or she should refer to the guidance in SAS No. 84, *Communications Between Predecessor and Successor Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 315). It provides guidance on communications between predecessor and successor auditors when a change in auditors is in process or has taken place, and it includes illustrative letters. SAS No. 84 also provides communications guidance when possible misstatements are discovered in financial statements reported on by a predecessor auditor.

Factors to Consider Under the Risk-Based Approach

3.34 When the engagement includes the selection of major programs using the risk-based approach, an auditor accepting, or contemplating accepting, an engagement should consider gathering information about the following:

- Federal awards expended by federal program
- Prior-period findings and questioned costs (including the corrective action plan and management decision related to the findings and summary schedule of prior audit findings)
- Whether the predecessor auditor used the exception that allows deviation from the risk-based approach during the last three years (see paragraph 7.20)
- Correspondence from program officials indicating potential problems
- New programs

- Changes to programs
- Amount of funding passed through to subrecipients by individual federal program
- Extent to which computer processing is used to administer federal programs
- Federal programs audited as major programs for the last two years

Timing of the Completion of the Audit and Reporting Submission Deadlines

3.35 When planning the timing of the audit, auditors should be aware that Circular A-133 requires that the audit be completed and the data collection form and reporting package (described in paragraphs 2.24, 2.25, 10.6, 10.7, and 10.71 through 10.73) be submitted to the federal clearinghouse within a certain time period. The timing requirements are discussed in detail in paragraphs 10.74 through 10.79.

3.36 As noted in paragraph 3.9, *Government Auditing Standards* contains guidance on certain areas, including materiality considerations. Paragraphs 4.6.1 and 4.6.2 of *Government Auditing Standards* state that “auditors’ consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.”

Determining the Major Programs to Be Audited

3.37 As discussed in paragraphs 2.16 through 2.19, Circular A-133 requires the auditor to use a risk-based approach to determine which federal programs are major programs. This determination will affect the scope of the audit and the compliance requirements to be tested. The determination of major programs is discussed further in chapter 7.

3.38 Circular A-133 requires the auditor to consider a lower level of materiality for purposes of reporting audit findings in the schedule of findings and questioned costs. The auditor should be cautious that this “audit finding” materiality not be confused with (a) the materiality used for planning and performing the single audit, (b) giving an opinion on the financial statements, and (c) giving an opinion on the auditee’s compliance with requirements having a direct and material effect on each major program (see paragraph 3.37 above).

Preliminary Assessment of Audit Risk

3.39 As required by SAS No. 54, 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. While not explicitly stated in SAS No. 54, it has generally been interpreted that the phrase “laws and regulations” implicitly includes provisions of contracts and grant agreements. (Auditors should note that *Government Auditing Standards* explicitly states that the auditor should design the audit to provide reasonable assurance of detecting material misstatements resulting from noncompliance

with the provisions of contracts or grant agreements that have a direct and material effect on the determination of financial statements amounts.) Circular A-133 further requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs. In developing an audit plan, the auditor should assess the risk that noncompliance may cause the financial statements to contain a material misstatement or may have a material effect on each major program. Furthermore, the auditor should consider risk factors related to the risk of noncompliance with those laws, regulations, and provisions of contracts and grant agreements and to the related control activities designed to prevent or to detect such noncompliance. As required by SAS No. 82, the auditor should also specifically assess the risk of material misstatement of the financial statements because of error or fraud and should consider that assessment in designing the audit procedures to be performed (see paragraphs 4.32 through 4.37). Audit risk is discussed in greater detail in paragraphs 6.7 through 6.12.

Audit Materiality Considerations

3.40 SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, provides guidance on the auditor's consideration of materiality when he or she plans and performs an audit of financial statements in accordance with GAAS. Materiality, as it relates to the financial statement audit, is further discussed in the following related AICPA Audit and Accounting Guides:

- *Not-for-Profit Organizations*
- *Audits of State and Local Governmental Units*
- *Health Care Organizations*
- *Audits of Colleges and Universities*⁵

3.41 In planning the consideration of the internal control and compliance aspects of the audit, the auditor should obtain from management the principal compliance requirements at the start of the audit (see paragraph 4.27 for a listing of possible audit procedures to assess management's identification of compliance requirements). The auditee and auditor may also ascertain the principal compliance requirements for the largest federal programs by referring to the *Compliance Supplement*. For programs not included in the *Compliance Supplement*, auditors should refer to part 7 of that document, which provides guidance for auditing programs not included in the *Compliance Supplement*. Among other things, part 7 instructs auditors to review the federal award document and referenced laws and regulations applicable to the program, the CFDA, and other audit guidance (see paragraph 6.30 for further information).

Materiality Guidance in Government Auditing Standards

3.42 As noted in paragraph 3.9, *Government Auditing Standards* contains guidance on certain areas, including materiality considerations. Paragraphs 4.8 and 4.9 of *Government Auditing Standards* state that "auditors' consideration of materiality is a matter of professional judgment and is influenced by their perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments are made in light of surrounding

⁵ Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

circumstances and necessarily involve both quantitative and qualitative considerations. In an audit of the financial statements of a government entity or an entity that receives government assistance, auditors may set lower materiality levels than in audits in the private sector because of the public accountability of the auditee, the various legal and regulatory requirements, and the visibility and sensitivity of government programs, activities, and functions.”

Materiality Differences Between the Financial Statement Audit and the Single Audit

3.43 In auditing compliance with requirements governing major programs in accordance with Circular A-133, the auditor’s consideration of materiality differs from that in an audit of financial statements in accordance with GAAS and *Government Auditing Standards*. In an audit of financial statements, materiality is considered in relation to the financial statements being audited. In designing audit tests and developing an opinion on an auditee’s compliance with requirements having a direct and material effect on each major program, however, the auditor considers materiality in relation to each major program (see paragraphs 6.13 through 6.16 for a further discussion of materiality considerations).

Materiality for Purposes of Reporting Audit Findings

3.44 Circular A-133 requires the auditor to consider a lower level of materiality for purposes of reporting audit findings in the schedule of findings and questioned costs. The auditor should be cautious that this “audit finding” materiality not be confused with (a) the materiality used for planning and performing the single audit, (b) giving an opinion on the financial statements, and (c) giving an opinion on the auditee’s compliance with requirements having a direct and material effect on each major program (see paragraph 3.43 above).

3.45 Among other findings that must be reported, Circular A-133 requires the auditor to report material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program in the schedule of findings and questioned costs (other findings that are required to be reported are described in paragraph 10.63). The auditor’s determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for the purpose of reporting an audit finding is in relation to a type of compliance requirement (for example, activities allowed or unallowed, cash management, eligibility, or reporting) for a major program or an audit objective identified in the *Compliance Supplement*.

3.46 Another common occurrence, particularly in a governmental environment, is the separation of a single audit between the principal auditor of the reporting entity and a secondary auditor of a component unit included in the financial statements of the reporting entity (see paragraph 3.27). The principal auditor’s report on the financial statements of the reporting entity most often refers to the report of the secondary auditor as it relates to the financial statements of the component unit. The principal auditor may also need to refer to the programs audited by other auditors in his or her reports on the schedule of expenditures of federal awards, compliance, and internal control related to federal awards, as they relate to federal awards administered by the component unit. In such cases, the auditor should follow the guidance in SAS No. 1, section 543.

3.47 For example, when the auditor discovers one or more instances of noncompliance involving the reporting type of compliance requirement for a particular major program, several materiality determinations must be made

using professional judgment. First, the auditor must decide whether the noncompliance is material to the reporting type of compliance requirement for the particular major program. If the auditor determines the noncompliance is material to the reporting type of compliance requirement, the noncompliance would be reported as a finding in the schedule of findings and questioned costs. Second, the auditor must decide whether the discovered noncompliance is material, either individually or when aggregated with other noncompliance findings, in relation to the particular major program taken as a whole. If the auditor determines the noncompliance is material to the major program taken as a whole, the auditor would express a qualified or adverse opinion on compliance with respect to the particular major program.

Determining Compliance Requirements

3.48 In planning the consideration of the internal control and compliance aspects of the audit, the auditor should obtain from management the principal compliance requirements at the start of the audit (see paragraph 4.27 for a listing of possible audit procedures to assess management's identification of compliance requirements). The auditee and auditor may also ascertain the principal compliance requirements for the largest federal programs by referring to the *Compliance Supplement*. For programs not included in the *Compliance Supplement*, auditors should refer to part 7 of that document, which provides guidance for auditing programs not included in the *Compliance Supplement*. Among other things, part 7 instructs auditors to review the federal award document and referenced laws and regulations applicable to the program, the CFDA, and previously issued compliance supplements (see paragraph 6.30 for further information).

Developing an Efficient Audit Approach

3.49 Auditors should consider planning and performing a single audit to achieve maximum audit efficiency. Examples of ways to achieve audit efficiency follow.

- The financial statement audit and the single audit could be planned at the same time.
- If the auditee's system administers more than one major program using common internal control, the transactions of those programs could be combined into one population for selecting sample sizes. When testing transactions selected from the major programs, the auditor could use the sample to test internal control over financial reporting, internal control over compliance, and compliance requirements.
- Since Circular A-133 requires the planning and performance of internal control work to assess control risk as low (unless weaknesses are found), the auditor could take advantage of the low assessed level of control risk when he or she performs the substantive testing of compliance.
- Helpful quality control materials (such as planning checklists and reporting checklists) could be used.

Joint Audits and Reliance on Others

3.50 Circular A-133 encourages auditees, whenever possible, to make positive efforts to utilize small business, minority-owned firms, and women's business enterprises. In keeping with the spirit of this provision, certain auditees

may engage such independent accounting firms on a joint-venture or subcontract basis. In these instances it may be necessary to refer to the work of other auditors. Prior to entering into an agreement to perform a joint audit or to subcontract with another firm, the auditor should consider SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, and Ethics Interpretation 101-10, *The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements*.

3.51 In some circumstances, each of the auditors participating in the single audit will jointly sign the audit reports. This is appropriate only when each auditor or firm has complied with GAAS and *Government Auditing Standards* and is in a position that would justify being the only signatory of the report.

3.52 In addition to the quality control requirements set forth in *Government Auditing Standards* (see paragraphs 3.12 and 3.13), cognizant agencies for audit have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews (note that the oversight agencies for audit may also perform these reviews). As a part of the cognizant agencies' evaluation of the completed reports of such engagements, and, as required by Circular A-133, the supporting audit working papers must be made available upon request of the representative of the federal agency. Audit working papers are typically reviewed at a location agreed upon by the cognizant agency for audit and the independent auditor. (See the additional discussion in paragraphs 3.20 and 3.24 regarding working paper access issues.)

3.53 If part of the single audit is performed by governmental auditors, the auditors should be satisfied that the government auditors meet the independence standards in chapter 3 of *Government Auditing Standards* as well as the CPE and quality control standards. These standards require that government auditors be free from organizational, personal, and external impairments to independence and that they maintain an independent attitude and appearance.

3.54 Another common occurrence, particularly in a governmental environment, is the separation of a single audit between the principal auditor of the reporting entity and a secondary auditor of a component unit included in the financial statements of the reporting entity (see paragraph 3.30). The principal auditor's report on the financial statements of the reporting entity most often refers to the report of the secondary auditor as it relates to the financial statements of the component unit. The principal auditor may also need to refer to the programs audited by other auditors in his or her reports on the schedule of expenditures of federal awards, compliance, and internal control related to federal awards, as they relate to federal awards administered by the component unit. In such cases, the auditor should follow the guidance in SAS No. 1, section 543.

Existence of Internal Audit Function

3.55 Another factor the auditor should consider when planning the single audit is whether the auditee has an internal audit function and the extent to which internal auditors are involved in monitoring compliance with specified requirements. The auditor should consider the guidance in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), when addressing the competence and objectivity of internal auditors; the nature, timing, and extent of work to be performed; and other related matters (for example, in obtaining an understanding of the entity's internal control over financial reporting and compliance, assessing audit risk, and performing substantive procedures).

Communications With the Cognizant Agency for Audit and Others

3.56 When professional judgment indicates it is appropriate, the auditor may communicate with the cognizant agency for audit, the oversight agency for audit, federal awarding agencies, pass-through entities, state auditors, or state awarding agencies, to aid in planning the audit. The auditor might want to consider documenting such communications, as well as any decisions rendered as a result. If a planning meeting is held, matters such as the following may be discussed:

- The audit plan
- The scope of the compliance testing of federal programs
- The intended use of the *Compliance Supplement*
- The identification of federal awards, including those that are considered to be major programs
- The form and content of the supplemental schedule of expenditures of federal awards
- The testing of the monitoring of subrecipients
- The scope of the review and testing of internal control
- The testing of compliance requirements
- The status of prior-year findings and questioned costs
- Federal agency or pass-through entity management decisions on prior-year findings
- Compliance requirements and any changes to those requirements

Understanding the Applicable State and Local Compliance and Reporting Requirements

Impact on Circular A-133 Audit

3.57 Auditors may be engaged to test and report on compliance with state and local laws and regulations in addition to testing and reporting on the compliance requirements imposed by *Government Auditing Standards* and Circular A-133. For example, there may be state-imposed state award requirements that provide state funds to political subdivisions or NPOs (in this example, the state is not a pass-through entity). Even though such nonfederal awards are not considered part of the total federal awards expended by the auditee and are not subject to audit in accordance with Circular A-133, auditors would still need to consider such laws and regulations under GAAS and *Government Auditing Standards*. Therefore, in connection with the financial statement audit, auditors should obtain an understanding of applicable state and local compliance and reporting requirements that have a direct and material effect on the financial statements being audited.

Compliance Audits of State or Local Grants

3.58 When engaged to audit one or more grants subject to state or local compliance requirements, the auditor should consider performing the following procedures:

- Determine whether the state or local government has a compliance supplement or other audit guide for the program.

- Inquire of management about the additional compliance auditing requirements applicable to the entity.
- Inquire of the audit divisions of the sponsoring agencies about the audit requirements applicable to the entity.
- Obtain any applicable audit guidance from the grantor agency (including any audit guides, amendments, administrative rulings, and the like) pertaining to the grant.
- Read the grant agreements and any amendments, including referenced laws and regulations.
- Review information about governmental audit requirements that is available from state societies of CPAs or associations of governments.
- When appropriate, discuss with the grantor agency the scope of the testing that is expected to be performed.

Compliance Audits Not Involving Governmental Assistance

3.59 Guidance for engagements related to management's written assertion about an entity's compliance with specified state or local laws, regulations, rules, or contracts not involving governmental financial assistance is provided in Statement on Standards for Attestation Engagements (SSAE) No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500).

Desk Reviews and On-Site Reviews

3.60 In addition to the quality control requirements set forth in *Government Auditing Standards* (see paragraphs 3.12 and 3.13), cognizant agencies for audit have implemented procedures for evaluating the quality of audits. These procedures include both desk reviews and on-site reviews (note that the oversight agencies for audit may also perform these reviews). As a part of the cognizant agencies' evaluation of the completed reports of such engagements, and, as required by Circular A-133, the supporting audit working papers must be made available upon request of the representative of the federal agency. Audit working papers are typically reviewed at a location agreed upon by the cognizant agency for audit and the independent auditor. (See the additional discussion in paragraphs 3.20 and 3.27 regarding working paper access issues.)

3.61 Whenever a review of the audit report or the working papers discloses an inadequacy, the audit firm is contacted for corrective action. Where major inadequacies are identified and the representative of the cognizant agency for audit determines that the audit report and the working papers are substandard, cognizant agencies may take further steps. In those instances in which the audit was determined to be substandard by the federal agency, the matter may be submitted to state boards of public accountancy.

Restriction on the Auditor's Preparation of Indirect Cost Proposals

3.62 Circular A-133 precludes the auditor who prepares the indirect cost proposal or cost allocation plan from performing the single audit when indirect costs recovered during the prior year by the auditee exceed \$1 million. This restriction applies to the base year used in the preparation of the indirect proposal or cost allocation plan and to any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs.

The implementation date for this provision is for audits of fiscal years beginning after June 30, 1998. For example, an auditor who prepares an indirect cost proposal or cost allocation plan that is used as the basis for charging indirect costs in the fiscal year ending June 30, 1999, is not permitted to perform the 1999 single audit (assuming that the indirect costs recovered during the prior year exceeded \$1 million).

Exit Conference

3.63 Upon completion of fieldwork, the auditor should consider holding a closing or exit conference with senior officials of the auditee. The exit conference gives the auditor an opportunity to obtain management's comments on the accuracy and completeness of his or her facts and conclusions, including whether or not management concurs with the audit findings. This conference also serves to provide the auditee with advance information so that it may initiate corrective action without waiting for a final audit report. In the case of decentralized operations, as at a university, auditors should consider having preliminary meetings with deans, department heads, and other operating personnel who have direct responsibility for financial management systems and the administration of sponsored projects.

3.64 The auditor should consider documenting the names of the auditors who conducted the exit conference, the names and positions of the representatives with whom exit conferences were held and any comments that they had, and other details of the discussions.

Chapter 4

FINANCIAL STATEMENT AUDIT CONSIDERATIONS UNDER CIRCULAR A-133

Introduction

4.1 Circular A-133 requires auditees to prepare financial statements that reflect their financial position, their results of operations or changes in net assets, and, where appropriate, their cash flows for the fiscal year. The financial statements must be for the same organizational unit and fiscal year that is chosen to meet the requirements of Circular A-133. However, organization-wide financial statements may also include departments, agencies, and other organizational units that have separate audits and prepare separate financial statements (see paragraph 4.5 below). Circular A-133 also requires auditees to prepare a schedule of expenditures of federal awards for the period covered by the financial statements. (The schedule of expenditures of federal awards is discussed in chapter 5.)

4.2 Circular A-133 does not prescribe the basis of accounting that must be used by auditees to prepare their financial statements. However, auditees are required to disclose the basis of accounting and significant accounting policies used in preparing the financial statements. Auditees must be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

4.3 Circular A-133 does, however, require the auditor to report whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP). This results in the expression of an opinion or a disclaimer of opinion. (Guidance on reporting on the financial statements of the auditee appears in chapter 10.) If the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP,¹ the auditor is still required to express or disclaim an opinion and should follow the reporting guidance in SAS No. 62, *Special Reports*.

4.4 The financial statements are also required to be audited in accordance with *Government Auditing Standards* (see paragraphs 3.8 through 3.23, 4.17 through 4.19, and 4.41). Circular A-133 does not impose on the financial statement audit any additional audit requirements beyond *Government Auditing Standards*.

4.5 The audit must cover the entire operations of the auditee, or at the option of the auditee, the audit may include a series of audits that cover departments, agencies, and other organizational units that expended or otherwise administered federal awards during the fiscal year, provided that each audit encompasses the financial statements and schedule of expenditures of federal awards for each such department, agency, and other organizational unit (see paragraph 3.30 for a further discussion).

¹ A comprehensive basis of accounting other than GAAP is defined in paragraph 4 of SAS No. 62, *Special Reports* (AICPA, *Professional Standards*, vol. 1, AU sec. 623.04).

4.6 In performing the financial statement audit, the auditor should refer to the accounting and auditing guidance applicable to specific industries as found in the following AICPA Audit and Accounting Guides: *Not-for-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*.²

4.7 In this chapter, the requirements of GAAS related to the auditor's consideration of compliance and internal control over financial reporting in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* in those areas are discussed.

Consideration of Internal Control Over Financial Reporting and Communication

4.8 In the following paragraphs the requirements of GAAS and *Government Auditing Standards* applicable to the auditor's consideration of internal control over financial reporting in a financial statement audit are described.

Summary of GAAS Requirements

4.9 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55* (AICPA, *Professional Standards*, vol. 1, AU sec. 319), provides guidance on the independent auditor's consideration of an auditee's internal control in an audit of financial statements in accordance with GAAS, defines internal control, describes the objectives and components of internal control, and explains how an auditor should consider internal control in planning and performing an audit.

4.10 When obtaining an understanding of internal control over financial reporting and assessing control risk for the assertions embodied in the financial statements, the auditor should refer to SAS No. 55, as amended by SAS No. 78, and to guidance applicable to specific industries as found in the AICPA Audit and Accounting Guides listed in paragraph 4.6.

Definition of Internal Control

4.11 The definition of internal control in both SAS No. 55, as amended by SAS No. 78, and Circular A-133 is consistent with the definition and description of internal control contained in *Internal Control—Integrated Framework*, published by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The definition is as follows:

Internal control means a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

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

² Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

Control Objectives

4.12 The three categories of control objectives described previously are what an auditee strives to achieve. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others regarding each separate purpose. In general, controls that are relevant to an audit of financial statements pertain to the auditee's objective of the reliability of financial reporting and involve the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP or a comprehensive basis of accounting other than GAAP (see footnote 1 of this chapter). However, controls pertaining to the operations and compliance objectives may also be relevant to a financial statement audit to the extent that they pertain to data the auditor evaluates or uses in applying auditing procedures to the financial statements. Controls relevant to an audit of the financial statements are referred to collectively in this SOP as "internal control over financial reporting" and are encompassed in the reporting on internal control required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP as "internal control over compliance" and are encompassed in the report on internal control required by Circular A-133 (see paragraphs 10.46 through 10.49). In a particular single audit engagement, some controls may be relevant to both the audit of the financial statements and the audit of compliance. When this occurs, those controls would be encompassed in both internal control reports. Section 505 of Circular A-133 provides guidance on reporting findings involving reportable conditions in internal control in such a circumstance (see paragraph 10.56).

Components of Internal Control

4.13 The five components of internal control are the control environment, risk assessment, control activities, information and communication, and monitoring. SAS No. 55, as amended by SAS No. 78, requires the auditor to obtain an understanding of each of those components that is sufficient to plan the audit by performing procedures to understand (a) the design of controls relevant to an audit of financial statements, and (b) whether they have been placed in operation. In all audits of financial statements, including those audited as part of a single audit, this understanding incorporates knowledge about the design of controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts, as well as knowledge about whether they have been placed in operation. After obtaining this understanding, the auditor assesses control risk for the assertions embodied in the account balance, transaction class, and disclosure components of the financial statements.

Relationship Between Objectives and Components

4.14 There is a direct relationship between the three categories of control objectives (what an auditee strives to achieve) and the control components (what is needed to achieve the objectives). Although an auditee's internal control addresses objectives in each of the categories referred to in the definition of internal control in paragraph 4.11, not all of these objectives and related controls are relevant to an audit of the auditee's financial statements.

Documentation Requirements

4.15 SAS No. 55, as amended by SAS No. 78, requires the auditor to document the understanding of the auditee's internal control components that

was obtained to plan the audit. In addition, the auditor should document the basis for his or her conclusions about the assessed level of control risk. The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as by the nature of the auditee's internal control (see paragraphs 3.20 through 3.22 for a discussion of the additional working paper and documentation requirements of *Government Auditing Standards*). Auditors should refer to SAS No. 55, as amended by SAS No. 78, for more detail on the documentation requirements related to internal control over financial reporting.

Communication Requirements

4.16 The auditor should consult the guidance in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), for guidance on identifying and reporting conditions that relate to an entity's internal control over financial reporting observed during an audit of financial statements (see also paragraphs 4.19 and 10.26 through 10.30). The auditor should also consult the guidance in SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380),* for required communications to persons who have responsibility for the oversight of the financial reporting process (see also paragraph 10.14).

Responsibilities Under Government Auditing Standards

Fieldwork

4.17 Other than the additional documentation requirement discussed in paragraphs 3.18 and 3.19, *Government Auditing Standards* does not prescribe any additional fieldwork standards with respect to the auditor's consideration of internal control over financial reporting beyond those required in an audit conducted in accordance with GAAS. However, paragraphs 4.21 through 4.30 of *Government Auditing Standards* provide guidance on certain aspects of internal control over financial reporting that are important to the judgments auditors make about audit risk and about the evidence needed to support their opinion on the financial statements. These aspects are summarized as follows:

- **Safeguarding of assets.** These are the controls that prevent or timely detect unauthorized transactions and unauthorized access to assets resulting in possible losses that are material to the financial statements. Therefore, the understanding of safeguarding controls assists auditors in planning the audit to detect material misappropriations as well as to assess other risks that the financial statements could be materially misstated.
- **Controls over compliance with laws and regulations.** These are important to auditors in identifying the types of potential misstatements that could occur and the factors that could affect the risk of material misstatement. Such information can help provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts.

* In December 1999, the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which, among other matters, amends SAS No. 61 to require the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999. Early adoption is permitted.

4.18 The auditor should consider this guidance as it relates to the consideration of the auditee's internal control over financial reporting in the audit of the financial statements.

Reporting and Communication

4.19 Reporting on the internal control over financial reporting under *Government Auditing Standards* differs from such reporting under SAS No. 60. *Government Auditing Standards* requires written reporting on internal control over financial reporting in all audits. SAS No. 60 requires communication (either written or oral) only when the auditor has noted reportable conditions. *Government Auditing Standards* requires a description of any reportable conditions noted, including the identification of those that are individually or cumulatively material weaknesses. SAS No. 60 permits, but does not require, the auditor to identify and communicate separately, as material weaknesses, those reportable conditions that, in the auditor's judgment, are considered to be material weaknesses. Finally, *Government Auditing Standards* requires communication of the following matters, which are not addressed by SAS No. 60: (a) a description of the scope of the auditor's testing of internal control and the results of those tests and (b) deficiencies in internal control that are not considered reportable conditions (see the discussion in paragraph 10.29). See paragraphs 3.24 through 3.25 and 10.26 through 10.30 for a more detailed discussion of the reporting and communication requirements related to internal control over financial reporting.

Compliance Considerations

4.20 The auditor should be aware of the unique characteristics of the compliance auditing environment. States, local governments, and not-for-profit organizations differ from commercial enterprises in that they may be subject to diverse compliance requirements. Management is responsible for ensuring compliance with relevant laws and regulations. That responsibility encompasses the identification of applicable laws and regulations and the establishment of internal control designed to provide reasonable assurance that the auditee complies with those laws and regulations.

4.21 In the following paragraphs, the requirements of GAAS that are applicable to the auditor's consideration of compliance in a financial statement audit are summarized and the additional requirements of *Government Auditing Standards* are discussed.

Summary of GAAS Requirements

General Guidance

4.22 SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, provides general guidance when the auditor is engaged to audit an entity that receives federal awards, including audits performed under GAAS, *Government Auditing Standards*, and Circular A-133. SAS No. 74 describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit and also discusses the auditor's responsibility for compliance auditing related to federal awards in an audit performed under Circular A-133. The auditor's responsibility for compliance auditing related to federal awards is discussed in chapter 6 of this SOP.

4.23 The auditor is required to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations, error, or fraud. SAS No. 54, *Illegal Acts by Clients*, describes the auditor's responsibility in a GAAS audit for considering laws and regulations and how they affect the financial statement audit. SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, describe the auditor's responsibility in a GAAS audit for the consideration of fraud and errors. The requirements of SAS Nos. 54, 82, and 47 are described in paragraphs 4.24 through 4.38.

SAS No. 54 Requirements

4.24 SAS No. 54 requires the auditor to design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from violations of laws and regulations that have a direct and material effect on the determination of financial statement amounts. This involves identifying laws and regulations that may have a direct and material effect on the determination of financial statement amounts, and then assessing the risk that noncompliance with these laws and regulations may cause the financial statements to contain a material misstatement. 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.

4.25 Although it has not been explicitly stated in SAS No. 54, the phrase "laws and regulations" has generally been interpreted to implicitly include the provisions of contract and grant agreements (see paragraph 3.17). Laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "compliance requirements." Violations of laws, regulations, and provisions of contracts and grant agreements are referred to in this SOP as "instances of noncompliance."

4.26 In considering whether the financial statements may be materially misstated because of instances of noncompliance, the auditor should—

- Assess whether management has identified compliance requirements that have a direct and material effect on the determination of amounts in the financial statements.
- Obtain an understanding of the possible effects of these compliance requirements on the determination of financial statement amounts.
- Assess the risk that a material misstatement of the financial statements has occurred because of instances of noncompliance.
- Design and conduct the audit to provide reasonable assurance of detecting such material noncompliance.

4.27 The auditor may consider performing the following procedures in assessing management's identification of these compliance requirements and in obtaining an understanding of their possible effects on the determination of financial statement amounts:

- a. Consider knowledge about these compliance requirements that has been obtained from prior years' audits.
- b. Discuss these compliance requirements with the auditee's chief financial officer, legal counsel, or grant administrators.

- c. Obtain written representation from management regarding the completeness of management's identification of compliance requirements (see paragraph 4.40).
- d. Review the relevant portions of any directly related agreements, such as those related to grants and loans.
- e. Identify sources of revenue, review any related agreements (for example, loan agreements or grant agreements) and inquire about the applicability of any overall governmental regulations to the accounting for the revenue.
- f. Obtain publications pertaining to compliance requirements. These publications often address federal tax and other reporting requirements, such as the Department of the Treasury and the Internal Revenue Service requirements pertaining to information returns and regulations concerning the calculation of arbitrage rebates and refunds.
- g. Obtain copies of, and review pertinent sections of, the state constitution, laws, and regulations concerning the auditee. The sections of these documents pertaining to financial reporting, debt, taxation, budget, and appropriation and procurement matters may be especially relevant.
- h. Review the minutes of meetings of the governing body of the auditee for the enactment of laws and regulations or information about contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- i. Inquire of the office of the federal, state, or local auditor or other appropriate audit oversight organization about the compliance requirements applicable to entities within their jurisdiction, including statutes and uniform reporting requirements.
- j. Review information about applicable federal and state program compliance requirements, such as the information included in the *Compliance Supplement*, the CFDA, and state and local policies and procedures.
- k. Review the guidance contained in the applicable AICPA Audit and Accounting Guides referred to in paragraph 4.6 and review the materials available from other professional organizations, such as state societies of CPAs or industry associations.
- l. Inquire of the audit, finance, or program administrators from which grants are received about the restrictions, limitations, terms, and conditions under which such grants were provided. These administrators can usually be helpful in identifying compliance requirements, which they may identify separately or publish in an audit guide.

4.28 In obtaining an understanding of the possible effects on financial statements of compliance requirements that are generally recognized by auditors to have a direct and material effect on the determination of financial statement amounts, the auditor may consider—

- The materiality of the effect on financial statement amounts.
- The level of management or employee involvement in the compliance-assurance process.
- The opportunity for concealment of instances of noncompliance.

4.29 As part of assessing the risk of material misstatement, the auditor should assess the risk that instances of noncompliance may cause such a material misstatement. Based on that assessment, the auditor should design the audit to provide reasonable assurance of detecting instances of noncompliance that are material to the financial statements. Therefore, the auditor should design the audit to provide reasonable assurance that the financial statements are free of material misstatements resulting from instances of noncompliance that have a direct and material effect on the determination of financial statement amounts (see paragraph 6.53 for a discussion of the impact on the financial statements of actual and projected errors noted in a single audit, and see paragraph 10.42 for a discussion of situations that could occur when the auditor reports on the results of compliance testing).

4.30 Auditees may be affected by many other laws and regulations, including those related to occupational safety and health, environmental protection, equal employment, food and drug, and price fixing. These laws and regulations generally concern an auditee's operations more than financial reporting and accounting. Their effect on an auditee's financial statements is indirect and normally takes the form of the disclosure of a contingent liability that follows from the allegation or determination of illegality. The auditor would not ordinarily have sufficient basis to recognize possible violations of these laws and regulations. Even when violations of such laws and regulations can have consequences that are material to the financial statements, the auditor may not become aware of the existence of the illegal act unless he or she is informed by the auditee, or unless there is evidence of an investigation or enforcement proceeding in the records, documents, or other information normally inspected in an audit of financial statements.³

4.31 If specific information comes to the auditor's attention that provides evidence concerning the existence of possible instances of noncompliance that could have a material indirect effect on the financial statements, the auditor should apply audit procedures specifically directed to ascertaining whether an instance of noncompliance occurred. However, because of the characteristics of such noncompliance, an audit made in accordance with GAAS provides no assurance that indirect-effect instances of noncompliance will be detected or that any contingent liabilities that may result will be disclosed.

SAS No. 82 Requirements

4.32 SAS No. 1, section 110, *Responsibilities and Functions of the Independent Auditor* (AICPA, *Professional Standards*, vol. 1, AU sec. 110), states that the auditor also 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. SAS No. 82 provides guidance to auditors in fulfilling that responsibility, as it relates to fraud, in an audit of financial statements conducted in accordance with GAAS.

4.33 Although fraud is a broad legal concept, the auditor's interest specifically relates to fraudulent acts that cause a material misstatement of financial statements. The primary factor that distinguishes fraud from error is

³ In addition, for compliance with laws and regulations that have an indirect effect on the determination of financial statement amounts, SAS No. 54 notes that, where applicable, the auditor should also inquire of management concerning (a) the client's policies relative to the prevention of illegal acts and (b) the use of directives issued by the client, as well as periodic representations obtained by the client, from management at appropriate levels of authority, concerning compliance with laws and regulations.

whether the underlying action that results in the misstatement of financial statements is intentional or unintentional. Two types of misstatements are relevant to the auditor's consideration of fraud in a financial statement audit: misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets. These two types of misstatements, as well as the characteristics of fraud, are discussed further in paragraphs 3 through 10 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.03 through 316.10).

4.34 The risk of material misstatement of the financial statements due to fraud is part of audit risk. Therefore, the auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed. In making this assessment, the auditor should consider fraud risk factors that relate to both misstatements arising from fraudulent financial reporting and misstatements arising from the misappropriation of assets in each of the following categories:

Misstatements Arising From Fraudulent Financial Reporting

- Management's characteristics and influence over the control environment
- Industry conditions
- Operating characteristics and financial stability

Misstatements Arising From the Misappropriation of Assets

- Susceptibility of assets to misappropriation
- Controls

The auditor should exercise professional judgment when considering (a) risk factors individually or in combination and (b) whether there are specific controls that mitigate the risk. Risk factors are discussed in greater detail in paragraphs 16 through 25 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU secs. 316.16 through 316.25).

4.35 As noted previously, an auditor's interest specifically relates to fraudulent acts that cause a material misstatement in the financial statements. When the auditor is identifying risk factors and other conditions in an audit of financial statements performed in conjunction with a single audit, the auditor's responsibilities under SAS No. 82 are expanded to include (in addition to the risk factors normally associated with financial statements) the consideration of risk factors associated with the receipt of federal awards that could present a material misstatement of the financial statements. Auditors may wish to refer to the AICPA practice aid titled *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which includes specific nonauthoritative guidance on applying the concepts of SAS No. 82 to several industries, including government, health care, and not-for-profit organizations. Among other things, it identifies example risk factors for those industries, including risk factors that relate to recipients of federal awards.

4.36 In planning the audit, the auditor should document in the working papers evidence of the performance of the assessment of the risk of material misstatement due to fraud. Where risk factors are identified as being present, the documentation should include (a) those risk factors identified and (b) the auditor's response to those risk factors, individually or in combination. In addition, if, during the performance of the audit, fraud risk factors or other

conditions are identified that cause the auditor to believe that an additional response is required, these risk factors or other conditions, as well as any further response that the auditor concluded was appropriate, should also be documented.

4.37 SAS No. 82 also contains requirements on the auditor's response to the results of the assessment of risk, the evaluation of audit test results, and communications about fraud to management, the audit committee, and others. Auditors should refer to SAS No. 82 for a description of the specific requirements in those areas (see also paragraphs 10.18 through 10.20).

SAS No. 47 Requirements

4.38 SAS No. 47, as amended by SAS No. 82, provides guidance to auditors in fulfilling the responsibility described in paragraph 4.32, as it relates to errors, in an audit of financial statements conducted in accordance with GAAS. Errors are described as unintentional misstatements, or as omissions of amounts or disclosures, in financial statements. Errors may involve (a) mistakes in gathering or processing data from which financial statements are prepared, (b) unreasonable accounting estimates arising from oversight or the misinterpretation of facts, and (c) mistakes in the application of accounting principles relating to amounts, classification, the manner of presentation, or disclosure. When the auditor is considering his or her responsibility to obtain reasonable assurance that the financial statements are free of material misstatement, there is no important distinction between error and fraud. There is a distinction, however, in the auditor's response to detected misstatements. An isolated, immaterial error in processing accounting data or in applying accounting principles is generally not significant to the audit. In contrast, when fraud is detected, the auditor should consider its implications for the integrity of management or employees and its possible effect on other aspects of the audit. Auditors should refer to SAS No. 47 for more detailed guidance.

Working Paper Documentation

4.39 The auditor should document the procedures performed to evaluate compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts in accordance with SAS No. 41, *Working Papers*. (See paragraphs 3.20 through 3.22 of this SOP for a discussion of the *Government Auditing Standards* requirements related to working papers.) The fraud risk factors identified and the auditor's response to those risk factors should be documented in accordance with SAS No. 82 (see paragraph 4.36). The auditor's understanding of internal control over financial reporting as it pertains to compliance with such laws and regulations, as well as the related assessment of control risk, should be documented in accordance with SAS No. 55, as amended by SAS No. 78 (see paragraph 4.15).

Written Representations From Management

4.40 SAS No. 85, *Management Representations*,* requires the auditor to obtain written representations from management as part of an audit conducted

* In December 1999, the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which, among other matters, amends SAS No. 85 to require that the management representation letter include an acknowledgment by management that the effects of any uncorrected financial statement 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 statement taken as a whole. It also requires that a summary of the uncorrected misstatements be included in or attached to the representation letter. This amendment is effective for audits of financial statements for periods beginning on or after December 15, 1999, with early adoption permitted.

in accordance with GAAS. It also includes an illustrative management representation letter and an appendix containing additional representations that may be appropriate to be included in a management representation letter in certain circumstances. With respect to compliance requirements affecting the financial statement audit, auditors should consider obtaining additional representations from management acknowledging that management (see paragraphs 6.68 and 6.69 for a discussion of additional management representations in a single audit)—

- a. Is responsible for compliance with the laws, regulations, and provisions of contracts and grant agreements applicable to the auditee.
- b. Is responsible for establishing and maintaining effective internal control over financial reporting.
- c. Has identified and disclosed to the auditor all laws, regulations, and provisions of contracts and grant agreements that have a direct and material effect on the determination of financial statement amounts.
- d. Has identified and disclosed to the auditor violations (or possible violations) of laws, regulations, and provisions of contracts and grant agreements whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

Additional Responsibilities Under Government Auditing Standards

4.41 *Government Auditing Standards* prescribes as part of the financial statement audit additional fieldwork and reporting requirements beyond those in GAAS that are related to compliance. The additional fieldwork responsibilities are related to audit communication, audit follow-up on known material findings and recommendations from previous audits, as well as to working paper access and documentation. (See paragraphs 3.16 through 3.22 of this SOP for a further discussion of the additional fieldwork requirements of *Government Auditing Standards*.) With regard to reporting, *Government Auditing Standards* requires, among other things, that the auditor report on the scope of his or her testing of compliance and present the results of those tests. See paragraphs 10.15 and 10.16 for a more detailed discussion of the *Government Auditing Standards* reporting requirements related to compliance.

Reasonable Assurance

4.42 SAS No. 1, section 230, “Due Professional Care in the Performance of Work” (AICPA, *Professional Standards*, vol. 1, AU sec. 230), states that since the auditor’s opinion on the financial statements is based on the concept of obtaining reasonable assurance, the auditor is not an insurer and his or her audit report does not constitute a guarantee. Therefore, the subsequent discovery that a material misstatement, whether from error or fraud, exists in the financial statements does not, in and of itself, evidence (a) failure to obtain reasonable assurance, (b) inadequate planning, performance, or judgment, (c) the absence of due professional care, or (d) a failure to comply with GAAS.

Chapter 5

SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS

Overview of Schedule Requirements

5.1 Circular A-133 requires the auditor to determine whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole. This schedule, prepared by the auditee, reports the total expenditures for each federal program (see paragraph 1.18 for the Circular A-133 definition of federal programs). In this chapter the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, non-cash awards, and endowment funds are described. The auditor's reporting on the schedule is discussed in paragraphs 10.36 and 10.37.

Identification of Federal Awards

Federal Agency and Pass-Through Entity Requirements

5.2 Circular A-133 requires federal agencies and pass-through entities to identify the federal awards made by informing each recipient or subrecipient of the CFDA title and number, the award's name and number, the award year, and whether the award is for R&D. When some of this information is not available, the federal agency or pass-through entity is required to provide the information necessary to describe the federal award clearly.

Auditee Requirements

5.3 Circular A-133 also requires the auditee to identify in its accounts all federal awards received and expended, as well as the federal programs under which they were received. Federal program and award identification includes, as applicable, the CFDA title and number, the award number and year, the name of the federal granting agency, and the name of the pass-through entity.

Auditor Assessment of Auditee Identification of Federal Programs

5.4 In assessing the appropriateness and completeness of the auditee's identification of federal programs in the schedule, the auditor should consider, among other matters, evidence obtained from audit procedures performed to evaluate the completeness and classification of recorded revenues and expenditures. This may include sending confirmations to granting federal agencies or pass-through entities in an audit of a subrecipient. When the auditee is unable to identify federally funded expenditures separately, the auditor should consider whether a reportable condition exists. If it does, a finding should be reported in the schedule of findings and questioned costs (see chapter 10 for a further discussion of reporting findings and the schedule of findings and questioned costs).

General Presentation Requirements

Basis of Accounting

5.5 Circular A-133 does not prescribe the basis of accounting that must be used by the auditee to prepare the schedule of expenditures of federal awards. Some auditees may choose to prepare the schedule on a basis of accounting that is different from that in the financial statements. In any case, the auditee is required to disclose the basis of accounting and the significant accounting policies used in preparing the schedule. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts in the schedule of expenditures of federal awards.

Required Schedule Contents

5.6 Circular A-133 requires the auditee to prepare a schedule of expenditures of federal awards for the period covered by the auditee's financial statements. At a minimum, the schedule should—

- List individual federal programs by federal agency. For federal programs included in a cluster of programs (see paragraphs 1.18, 1.19, and 2.18), list individual federal programs within a cluster of programs. For R&D, the total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services (the federal agency).
- Include, for federal awards received as a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity.
- Provide the total federal awards expended for each individual federal program and the CFDA number or other identifying number when the CFDA information is not available.
- Include notes that describe the significant accounting policies used in preparing the schedule.
- Identify, to the extent practical, the total amount provided to subrecipients by pass-through entities from each federal program (see chapter 9 for a further discussion of the audit considerations of federal pass-through awards).
- Include, in either the schedule or a note to the schedule, the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end (see paragraph 5.13).

Example schedules of expenditures of federal awards appear in appendix C.

Providing Additional Information

5.7 Although not required, the auditee may choose to provide other information (in addition to the foregoing requirements) that is requested by federal awarding agencies and pass-through entities to make the schedule easier to

use. For example, when a federal program has multiple award years, the auditee may choose to list the amount of federal awards expended for each award year separately, if so requested by a federal agency.

Schedule Not in Agreement With Other Federal Award Reporting

5.8 Auditors should note that the information included in the schedule may not fully agree with other federal award reports that the auditee submits directly to federal granting agencies because, among other reasons, the award reports (a) may be prepared for a different fiscal period and (b) may include cumulative (from prior years) data rather than data for the current year only.

Inclusion of Nonfederal Awards

5.9 Circular A-133 does not require nonfederal awards (for example, state awards) to be presented in the schedule. However, to meet state or other requirements, auditees may decide to include such awards in the schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

CFDA Number Not Available

5.10 The auditee may be unable to obtain the CFDA number, which is sometimes the case for new federal programs and R&D programs. In addition, cost-type contracts will normally not have a CFDA number. When the CFDA number is not available, the auditee should indicate that fact and should include in the schedule the program's name and, if available, other identifying number.

Pass-Through Awards

Treatment of Pass-Through Awards

5.11 Circular A-133 defines a subrecipient as an entity that expends federal awards that are received from a pass-through entity to carry out a federal program. State or local government redistributions of federal awards to subrecipients, known as "pass-through awards," should be treated by the subrecipient as though they were received directly from the federal government. Accordingly, pass-through awards should be included in the scope of the single audit on the same basis as that of federal awards that are received directly. The audit considerations of federal pass-through awards are discussed further in chapter 9. As noted in paragraph 5.6, in addition to the other general presentation requirements, Circular A-133 requires the schedule to include the name of the pass-through entity and the identifying number assigned by the pass-through entity for federal awards received as a subrecipient.

Commingled Assistance

5.12 The individual sources (that is, federal, state, and local) of federal awards may not be separately identifiable because of commingled assistance

from different levels of government. If the commingled portion cannot be separated to specifically identify the individual funding sources, the total amount should be included in the schedule, with a footnote describing the commingled nature of the funds.

Noncash Awards

Treatment of Noncash Awards

5.13 Most federal awards are in the form of cash awards. However, there are a number of federal programs that do not involve cash transactions. These programs may include food stamps, commodities, loan guarantees, loans, surplus property, interest rate subsidies, or insurance. Circular A-133 requires the value of federal awards expended in the form of noncash assistance (such as loan guarantees, loans, insurance programs, surplus property, food stamps issued, or commodities distributed) to be reported either on the face of the schedule or disclosed in the notes to the schedule. The OMB states in Circular A-133 that although it is not required, it is preferable to present this information in the schedule rather than in the notes to the schedule. See paragraphs 2.13 and 2.14 for a discussion on determining when awards, including noncash awards, are considered to be expended.

Determining the Value of the Noncash Awards Expended

5.14 Table 5.1 shows the bases generally used to determine the value of noncash awards expended (see section 205 of Circular A-133 for additional details).

Loan and Loan Guarantee Continuing Compliance Requirements

5.15 As noted previously, in determining the value of total noncash awards expended for loans and loan guarantees, the balances of loans from previous years must be included if the federal government imposes continuing compliance requirements. Circular A-133 does not specifically define the term *continuing compliance requirements*. Therefore, it is a matter of judgment as to whether continuing compliance requirements are significant enough to require inclusion of prior-year loan or loan guarantee balances. For example, if in a prior year an auditee expended the proceeds of a federal loan to construct a building, and the current-year activity consists only of loan repayments and a requirement by the federal lender for the auditee to submit a report that only details loan payment information, it may not be necessary to include the prior year's loan balance in determining the total amount of loans expended. However, if the federal lender requires the auditee to ensure on an ongoing basis that a certain percentage of the building is rented to low-income residents, it would likely be necessary to include the prior year's loan balance in determining the total amount of loans expended. The auditor should consider contacting the federal agency Office of Inspector General for assistance in determining whether continuing compliance requirements are significant enough to require inclusion of the balances of prior loans or loan guarantees.

Table 5.1**Determining the Value of Noncash Awards Expended**

<i>Types of Noncash Awards</i>	<i>Basis Used to Determine the Value of Noncash Awards Expended</i>
Loans and loan guarantees	Value of new loans made or received during the fiscal year plus the balance of loans from previous years for which the federal government imposes continuing compliance requirements (see paragraph 5.15), plus any interest subsidy, cash, or administrative cost allowance received.
Loans and loan guarantees (loans) at institutions of higher education	When loans are made to students but the institution of higher education does not make the loans, only the value of loans made during the year are considered federal awards expended. The balance of loans for previous years is not included because the lender accounts for the prior balances.
Insurance	Fair market value of insurance contract at the time of receipt, or the assessed value provided by the federal agency.
Food stamps	Fair market value of food stamps at the time of receipt, or the assessed value provided by the federal agency.
Commodities	Fair market value of commodities at the time of receipt, or the assessed value provided by the federal agency.
Donated property or donated surplus property	Fair market value of donated property or donated surplus property at the time of receipt, or the assessed value provided by the federal agency.
Free rent	Fair market value of free rent at the time of receipt, or the assessed value provided by the federal agency. Free rent is not considered an award expended unless it is received as part of an award to carry out a federal program.

* The proceeds of loans that were received and expended in prior years are not considered federal awards expended when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

Endowment Funds

5.16 Circular A-133 states that the cumulative balance of federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

Chapter 6

COMPLIANCE AUDITING APPLICABLE TO MAJOR PROGRAMS

6.1 In this chapter the auditor's consideration of compliance requirements applicable to major programs in a single audit under Circular A-133 is discussed (as noted in paragraph 11.5, much of the guidance in this chapter would also be applicable to a program-specific audit when a program-specific audit guide is not available). The consideration of internal control over compliance for major programs is discussed in chapter 8. The related reporting requirements are discussed in chapter 10. The auditor's consideration of the auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements in a financial statement audit is discussed in chapter 4.

Single Audit Compliance Objectives

6.2 In addition to a financial statement audit in accordance with GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs (these are hereinafter referred to as "compliance requirements"). A single audit results in the auditor expressing an opinion on the auditee's compliance with these compliance requirements for each of its major programs. To express such an opinion, the auditor accumulates sufficient evidence by planning and performing tests of transactions and such other auditing procedures as are necessary in support of the entity's compliance with applicable compliance requirements, thereby limiting audit risk to an appropriately low level.

Responsibilities of Auditee

6.3 The auditee is responsible (a) for complying with the compliance requirements related to each of its federal programs and (b) for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. The auditor should obtain management's written representations regarding its compliance and internal control responsibilities as discussed in paragraphs 6.68 and 6.69.

6.4 The form and extent of the documentation of management's compliance will vary depending on the nature of the compliance requirements and the size and complexity of the entity. The auditee may have documentation in the form of accounting or statistical data, case files, entity policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, or internal auditors' reports.

Use of Professional Judgment

6.5 The planning, conduct, and evaluation of the results of compliance testing in a single audit require the auditor to exercise professional judgment.

The following factors may be considered by the auditor in applying his or her professional judgment:

- The assessment of inherent risk, control risk, and fraud risk
- The assessment of materiality
- The evidence obtained from other auditing procedures
- The amount of expenditures for the program
- The diversity or homogeneity of expenditures for the program
- The length of time that the program has operated, or changes in its conditions
- The current and prior auditing experience with the program, particularly findings in previous audits and other evaluations (that is, inspections, program reviews, or system reviews required by the federal acquisition regulations)
- The extent to which the program is carried out through subrecipients, as well as the related monitoring activities
- The extent to which the program contracts for goods or services
- The level to which the program is already subject to program reviews or other forms of independent oversight
- The expectation of noncompliance or compliance with the applicable compliance requirements
- The extent to which computer processing is used to administer the program, as well as the complexity of the processing
- Whether the program has been identified as being high-risk by the OMB in the *Compliance Supplement*

Audit Risk Considerations

6.6 To express an opinion on compliance, the auditor accumulates sufficient evidence in support of compliance, thereby limiting audit risk to an appropriately low level. The auditor's consideration of audit risk and materiality when he or she plans and performs a single audit is similar to the consideration in a financial statement audit in accordance with SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended by SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. 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.

Components of Audit Risk

6.7 Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on compliance. It is composed of inherent risk, control risk, fraud risk, and detection risk. For the purposes of a single audit, these components are defined as follows:

- *Inherent risk*—the risk that material noncompliance with a major program's compliance requirements could occur, assuming there is no related internal control

- *Control risk*—the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the entity's internal control
- *Fraud risk*—the risk that intentional material noncompliance with a major program's compliance requirements could occur
- *Detection risk*—the risk that the auditor's procedures will lead him or her to conclude that noncompliance that could be material to a major program does not exist when, in fact, such noncompliance does exist

In paragraphs 6.8 through 6.12, each of these components of audit risk is discussed and an explanation of how the components of audit risk interrelate in providing a basis for the auditor's opinion on compliance is given.

Inherent Risk

6.8 In assessing inherent risk, the auditor should consider factors that are relevant to compliance engagements. Such factors include the following (the factors listed in paragraph 6.5 should also be considered):

- The complexity of the compliance requirements
- The length of time the entity has been subject to the compliance requirements
- Prior experience with the entity's compliance
- The potential impact of noncompliance, both qualitatively and quantitatively

6.9 The auditor's assessment of inherent risk over major programs may be performed in part when the auditor is determining major programs using the risk-based approach (see paragraph 7.36). The nature of some programs may indicate higher inherent risk. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides the following examples for program characteristics with potentially higher inherent risks:

- Complex programs and the extent to which a program contracts for goods and services have the potential for higher risk. For example, federal programs that disburse funds through third-party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high risk for time-and-effort reporting but may otherwise be at low risk.
- The phase of a federal program's life cycle at the federal agency may indicate risk. For example, a new program with new or interim regulations may have a higher risk than an established program with time-tested regulations. In addition, significant changes in federal programs, laws, or regulations or in the provisions of contracts or grant agreements may increase risk.
- The phase of a program's life cycle at the auditee may indicate risk. For example, during the first and last years in which an auditee participates in a program, the risk may be higher because of the start-up or closeout of the program's activities and staff.
- Type B programs with larger federal awards expended would be of higher risk than would programs with substantially smaller federal awards expended.

Control Risk

6.10 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs, to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. The circular does not, however, actually require the achievement of a low assessed level of control risk. The assessment of control risk contributes to the auditor's evaluation of the risk that material noncompliance exists in a major program. The process of assessing control risk (together with assessing inherent risk and fraud risk) provides evidential matter about the risk that such noncompliance may exist. The auditor uses this evidential matter as part of the reasonable basis for his or her opinion on compliance. The auditor's consideration of internal control over compliance for major programs, including the assessment of control risk, is discussed in chapter 8.

Fraud Risk

6.11 SAS No. 82 provides guidance to the auditor on his or her responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement due to fraud (see paragraphs 4.32 through 4.37). Because SAS No. 82 only applies to an audit of financial statements, its requirements do not apply to an audit of an auditee's compliance with specified requirements applicable to its major programs. However, as part of assessing audit risk in a single or program-specific audit, the auditor should specifically assess the risk of material noncompliance with a major program's compliance requirements occurring due to fraud. The auditor should consider that assessment in designing the audit procedures to be performed. Auditors may wish to refer to the AICPA practice aid titled, *Considering Fraud in a Financial Statement Audit: Practical Guidance for Applying SAS No. 82*, which identifies example risk factors that relate to recipients of federal awards. When the auditor has assessed fraud risk and has deemed that a further response is necessary, the guidance in paragraphs 26 through 32 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.26–.32) may be helpful.

Detection Risk

6.12 In determining an acceptable level of detection risk, the auditor considers his or her assessments of inherent risk, control risk, and fraud risk, and the extent to which he or she seeks to restrict the audit risk related to the major program. As assessed inherent risk, control risk, or fraud risk decreases, the acceptable level of detection risk increases. Accordingly, the auditor may alter the nature, timing, and extent of the compliance tests performed based on the assessments of inherent risk, control risk, and fraud risk. Circular A-133 states that compliance testing must include tests of transactions and such other auditing procedures necessary to provide the auditor with sufficient evidence to support an opinion on compliance. Such compliance testing serves to limit detection risk.

Materiality Considerations

6.13 In a compliance audit, the auditor's consideration of materiality differs from that in an audit of financial statements (see paragraphs 3.40 through 3.47). Materiality is affected by (a) the nature of the compliance requirements, which may or may not be quantifiable in monetary terms, (b) the

nature and frequency of noncompliance identified with an appropriate consideration of sampling risk, and (c) qualitative considerations, such as the needs and expectations of federal agencies and pass-through entities. Qualitative factors that indicate that an identified instance of noncompliance may be immaterial include (a) a low risk of public or political sensitivity, (b) a single exception that has a low risk of being pervasive, or (c) an indication, based on the auditor's judgment and experience, that the affected federal agency or pass-through entity would normally not need to resolve the finding or take follow-up action.

Materiality Judgments About Compliance Applied to Each Major Program Taken as a Whole

6.14 In designing audit tests and developing an opinion on the auditee's compliance with compliance requirements, the auditor should apply the concept of materiality to each major program taken as a whole, rather than to all major programs combined.

6.15 For purposes of evaluating the results of compliance testing, a material instance of noncompliance is defined as a failure to follow requirements, or a violation of prohibitions, established by law, regulation, contract, or grant that results in an aggregation of noncompliance (that is, the auditor's best estimate of the overall noncompliance) that is material to the affected federal program. It should be noted that several instances of noncompliance that may not be individually material should be assessed to determine if, in the aggregate, they could have a material effect. Because the auditor expresses an opinion on each major program and not on all the major programs combined, reaching a conclusion about whether the instances of noncompliance (either individually or in the aggregate) are material to a major program requires consideration of the type and nature of the noncompliance, as well as the actual and projected effect on each major program in which the noncompliance was noted. Instances of noncompliance that are material to one major program may not be material to a major program of a different size or nature. In addition, the level of materiality relative to a particular major program can change from one audit to the next.

Effect of Material Noncompliance on the Financial Statements

6.16 If the tests of compliance reveal material noncompliance at the major program level, the auditor should consider its effect on the financial statements. The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. (See also paragraphs 6.53 and 10.42.)

Performing a Compliance Audit

6.17 The auditor should exercise (a) due care in planning and performing the audit and in evaluating the results of his or her audit procedures, and (b) the proper degree of professional skepticism to achieve reasonable assurance that material noncompliance will be detected.

6.18 In performing compliance tests, the auditor should—

- a. Identify the auditee's major programs to be tested and reported on for compliance (paragraph 6.19 and chapter 7).
- b. Identify the applicable compliance requirements (paragraphs 6.20 through 6.30).

- c. Plan the engagement (paragraphs 6.31 through 6.34 and chapter 3).
- d. Consider relevant portions of the entity's internal control over compliance for major programs (paragraph 6.35 and chapter 8).
- e. Obtain sufficient evidence, which involves testing compliance with applicable compliance requirements (paragraphs 6.36 through 6.47).
- f. Consider subsequent events (paragraphs 6.48 through 6.50).
- g. Form an opinion about whether the auditee complied with the applicable compliance requirements (paragraphs 6.51 through 6.60).
- h. Perform follow-up procedures on previously identified findings (paragraph 6.61 through 6.67).

Identifying Major Programs to Be Tested

6.19 Circular A-133 requires the auditor to determine the major programs to be tested in a single audit using a risk-based approach. The application of the risk-based approach to determine major programs is discussed in chapter 7.

Identifying Applicable Compliance Requirements

6.20 The auditor must determine the applicable compliance requirements to be tested and reported on in a single audit (that is, those laws, regulations, and provisions of contracts or grant agreements that may have a direct and material effect on each major federal program). The auditor should use professional judgment in making this determination.

Compliance Supplement

6.21 The *Compliance Supplement* is based on the requirements of the Single Audit Act and Circular A-133, which provide for the issuance of a compliance supplement to assist auditors in performing the required audits (see paragraphs 1.27 through 1.29, 2.34, and 2.35 for additional discussion of the *Compliance Supplement* and for instructions on how to obtain a copy). The *Compliance Supplement* identifies the fourteen types of compliance requirements applicable to most federal programs. It also includes the compliance requirements specific to certain of the largest federal programs. Part 7 of the *Compliance Supplement* provides guidance to assist the auditor in identifying the compliance requirements for federal programs not included in the *Compliance Supplement* (see also paragraph 6.30).

Fourteen Types of Compliance Requirements

6.22 Part 3 of the *Compliance Supplement* lists and describes the fourteen types of compliance requirements and the related audit objectives that the auditor should consider in every audit conducted under Circular A-133, with the exception of program-specific audits performed in accordance with a federal agency's program specific audit guide (see paragraph 11.4). Suggested audit procedures are also provided to assist the auditor in planning and performing tests of the auditee's compliance with the requirements of federal programs. The auditor's judgment will be necessary to determine whether the suggested audit procedures are sufficient to achieve the stated audit objectives and whether additional or alternative audit procedures are needed (see paragraph 6.44). The fourteen types of compliance requirements are as follows:

- A—activities allowed or unallowed
- B—allowable costs/cost principles

- C—cash management
- D—Davis-Bacon Act
- E—eligibility
- F—equipment and real property management
- G—matching, level of effort, earmarking
- H—period of availability of federal funds
- I—procurement and suspension and debarment
- J—program income
- K—real property acquisition and relocation assistance
- L—reporting
- M—subrecipient monitoring
- N—special tests and provisions

The auditor should consider the applicability of these compliance requirements to the auditee's major programs. Part 2 of the *Compliance Supplement* provides a matrix that is useful to the auditor for this purpose by identifying whether particular compliance requirements apply to the federal programs included in the *Compliance Supplement*. In making a determination not to test a compliance requirement identified as applicable to a particular program, the auditor must conclude either that the requirement does not apply to the particular auditee or that noncompliance with the requirements could not have a material effect on a major program.

Keeping Abreast of Changes in Compliance Requirements

6.23 Circular A-133 states that an audit of the compliance requirements related to federal programs contained in the *Compliance Supplement* will meet the requirements of the circular. However, it also states that when there have been changes to the compliance requirements and the changes are not reflected in the *Compliance Supplement*, the auditor must determine the current compliance requirements and modify the audit procedures accordingly.

6.24 Although Circular A-133 provides that federal agencies are responsible to inform the OMB annually of any updates needed to the *Compliance Supplement*, the auditor should recognize that laws and regulations change periodically and that delays will occur between such changes and revisions to the *Compliance Supplement*. Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current. Besides describing the compliance requirements, the *Compliance Supplement* includes references to the Code of Federal Regulations and other sources of information about the requirements. The auditor may refer to those other sources of information to identify significant changes to the requirements or perform other procedures, including the following:

- Discussions with appropriate individuals within the auditee organization (that is, the chief financial officer, internal auditors, legal counsel, the compliance officer, or grant or contract administrators)
- A review of contracts or grant agreements, new guidance material issued by the granting agency or pass-through entity (for example, handbooks and operating procedures), and correspondence from the granting agency or pass-through entity

- An inquiry of granting agency personnel (appendix III of the *Compliance Supplement* includes a listing of federal agency contacts, including addresses, phone numbers, and E-mail or Web page addresses that could be useful if the auditor decides to make such an inquiry)

Considering Additional Provisions of Contracts or Grant Agreements

6.25 The *Compliance Supplement* states that in addition to the compliance requirements identified in the supplement, auditors need to consider whether there are any provisions of contracts or grant agreements that are unique to a particular entity (for example, the grant agreement may specify the matching percentage, or an entity may have agreed to additional requirements that are not required by law or regulation, perhaps as part of a resolution of prior audit findings).

6.26 Therefore, in using the *Compliance Supplement* to identify applicable compliance requirements, the auditor needs to consider—

- a. The applicability to the federal program of the fourteen types of compliance requirements identified in part 3 of the *Compliance Supplement*.
- b. Additional compliance requirements specific to the federal program as identified in part 4 of the *Compliance Supplement*.
- c. Any provisions of contracts or grants that are unique to the particular entity.

Compliance Requirements Specific to Certain Federal Programs

6.27 Part 4 of the *Compliance Supplement* discusses program objectives, program procedures, and compliance requirements that are specific to each federal program included. With the exception of special tests and provisions, the auditor should refer to part 3 of the *Compliance Supplement* for the audit objectives and suggested audit procedures that pertain to the compliance requirements associated with each program. Since special tests and provisions are unique to each program, the audit objectives and suggested audit procedures for each program are included in part 4.

Compliance Requirements Specific to a Cluster of Programs

6.28 As noted in paragraph 2.18, a cluster of programs is a grouping of closely related programs that have similar compliance requirements (for example, SFA, R&D, and other clusters). Part 5 of the *Compliance Supplement* identifies those programs that are considered to be clusters of programs. It also provides compliance requirements, audit objectives, and suggested audit procedures for the clusters.

Relationship of the Compliance Supplement to Federal Program Audit Guides

6.29 The *Compliance Supplement* states that for single audits, the supplement replaces federal agency audit guides and other audit requirement documents for individual federal programs.¹ Accordingly, for a federal program

¹ Auditors should note that two federal agencies, the Department of Housing and Urban Development and the Department of Education have issued interim supplements to address the requirements of certain agency programs. Those supplements provide guidance similar to that provided in part 4 of the *Compliance Supplement*. A description of the supplements and the authoritative status of each are discussed in part 1 of the *Compliance Supplement*. Auditors should refer to the *Compliance Supplement* to determine whether to use the interim supplements or the *Compliance Supplement* for the federal programs included in the supplements. As of the date of this SOP, the OMB has indicated that the federal programs included in the Department of Education interim supplement will be included in the next revision of the *Compliance Supplement*.

included in the *Compliance Supplement* and having a separate federal program audit guide or other federal program audit requirement documents, the auditor needs to consider only those compliance requirements in the *Compliance Supplement* when performing a single audit (versus a program-specific audit).

Federal Programs Not Included in the Compliance Supplement

6.30 The *Compliance Supplement* does not include all federal programs from which an auditee may receive federal awards. Circular A-133 states that for those federal programs not covered in the *Compliance Supplement*, the auditor should use the fourteen types of compliance requirements (see paragraph 6.22) contained in the supplement as guidance for identifying the types of compliance requirements to test, and should determine the requirements governing the federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements. The auditor should follow the guidance in part 7 of the *Compliance Supplement* for identifying the applicable compliance requirements to test and report on in a single audit. That guidance outlines the following steps to determine which compliance requirements to test:

- a. Identify the applicable compliance requirements for the federal program.
- b. Determine which of the compliance requirements identified in step *a* could have a direct and material effect on the major program.
- c. Determine which of the compliance requirements identified in step *b* are susceptible to testing by the auditor.
- d. Determine which of the fourteen types of compliance requirements would the compliance requirements identified in step *c* fall into.
- e. For special tests and provisions, determine the applicable audit objectives and audit procedures.

Part 7 of the *Compliance Supplement* provides more detailed guidance on the steps to perform to identify applicable compliance requirements.

Planning the Engagement

General Considerations

6.31 Planning a compliance audit involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, auditors need to have sufficient knowledge to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on compliance. Proper planning and supervision contribute to the effectiveness of audit procedures. Proper planning directly influences the selection of appropriate procedures and the timeliness of their application, and proper supervision helps ensure that planned procedures are appropriately applied.

6.32 Factors to be considered by the auditor in planning a compliance audit include (a) the anticipated level of audit risk related to the compliance requirements on which the auditor will report (see paragraphs 6.6 through 6.12), (b) preliminary judgments about materiality levels for audit purposes (see paragraphs 6.13 through 6.16), and (c) conditions that may require extension or modification of audit procedures.

6.33 The nature, timing, and extent of planning will vary with the nature and complexity of the compliance requirements and the auditor's prior experience with the auditee. As part of the planning process, the auditor should consider the nature, timing, and extent of the work to be performed to accomplish the objectives of the compliance audit. Nevertheless, as the compliance audit progresses, changed conditions may make it necessary to modify planned procedures. For discussion of additional planning considerations, see chapter 3.

Multiple Components

6.34 In a compliance audit in which the auditee has operations in several components (for example, locations or branches), the auditor may determine that it is not necessary to test compliance with requirements at every component. In making such a determination and in selecting the components to be tested, the auditor should consider such factors as the following: (a) the degree to which the specified compliance requirements apply at the component level, (b) judgments about materiality, (c) the degree of centralization of the records, (d) the effectiveness of controls, particularly those that affect management's direct control over the exercise of authority delegated to others, as well as its ability to supervise activities at various locations effectively, (e) the nature and extent of operations conducted at the various components, and (f) the similarity of operations and controls over compliance for different components. See paragraph 8.13 for a discussion of internal control considerations for multiple components.

Consideration of Internal Control Over Compliance for Major Programs

6.35 The auditor should obtain an understanding of relevant portions of internal control over compliance sufficient to plan the audit and to assess control risk for compliance with specified requirements. In planning the audit, the auditor should use this knowledge to identify types of potential noncompliance, to consider factors that affect the risk of material noncompliance, and to design appropriate tests of compliance. Circular A-133 specifically requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs. Circular A-133 also requires the auditor to perform testing of controls as planned. In some instances, the auditor may be able to perform compliance testing for major programs concurrently with tests of controls (see paragraph 3.49). Any reportable conditions in internal control over compliance for major programs that are noted are required to be reported as an audit finding (see paragraph 10.63). Control risk is discussed further in paragraph 6.10, and the auditor's consideration of internal control over compliance for major programs (including the final control risk assessment and the performance of tests of controls) is discussed in more detail in chapter 8.

Performing Compliance Testing

6.36 Circular A-133 requires that compliance testing include tests of transactions and such other auditing procedures as are necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program. Such compliance testing may be performed (a) concurrently with tests of controls, (b) as substantive testing, or (c) as a combination

of the two. In performing compliance testing, the auditor attempts to obtain reasonable assurance that the auditee complied, in all material respects, with the compliance requirements. This includes designing the compliance audit to detect both intentional and unintentional noncompliance. Absolute assurance is not attainable because of factors such as the need for judgment, the use of sampling, and the inherent limitations of internal control over compliance and because much of the evidence available to the auditor is persuasive rather than conclusive in nature. Furthermore, procedures that are effective for detecting unintentional noncompliance may be ineffective for detecting noncompliance that is intentional and is concealed through a collusion between the client's personnel and third parties or among the management or employees of the client. Therefore, the subsequent discovery that material noncompliance exists does not, in and of itself, evidence inadequate planning, performance, or judgment on the part of the auditor.

6.37 In determining the nature, timing, and extent of tests to perform, the auditor's professional judgment regarding the appropriate level of detection risk should be used. In applying his or her judgment, the auditor should be aware that small sample sizes for tests of details with a low dollar value and from a large population generally do not, by themselves, provide sufficient evidence. In determining the nature, timing, and extent of the testing of an auditee's compliance with compliance requirements, the auditor should consider audit risk and materiality related to each major program. The auditor plans compliance tests to reduce detection risk to an acceptable level. The evidence provided by these tests, along with evidence regarding inherent risk and control risk, provides the basis for expressing an opinion on whether the auditee complied, in all material respects, with the compliance requirements for each major program.

6.38 In determining the nature of his or her tests of compliance with requirements governing major programs, the auditor should consider the nature of those requirements. For example, to test compliance with requirements applicable to the allowability of expenditures using program funds, audit procedures should be designed to provide the auditor with sufficient evidential matter to evaluate how management expended the funds.

Sufficient Evidence

6.39 The auditor should apply procedures to provide reasonable assurance of detecting material noncompliance. The selection and application of procedures that will accumulate evidence that is sufficient in the circumstances to provide a reasonable basis for expressing an opinion on compliance require the careful exercise of professional judgment. A broad array of available procedures may be applied in a compliance audit. In establishing a proper combination of procedures to restrict audit risk appropriately, the auditor should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

- a. Evidence obtained from independent sources outside an entity provides greater assurance of an entity's compliance than evidence secured solely from within the entity.
- b. Information obtained from the auditor's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.

- c. The more effective the internal control, the greater the assurance it provides about the entity's compliance.

6.40 Thus, in the hierarchy of available audit procedures, those that involve search and verification (for example, inspection, confirmation, or observation)—particularly when independent sources outside the entity are used—are generally more effective in reducing audit risk than are those involving internal inquiries and comparisons of internal information (for example, analytical procedures and discussions with the individuals responsible for compliance).

6.41 In a compliance audit, the auditor's objective is to accumulate sufficient evidence to limit audit risk to a level that is, in the auditor's professional judgment, appropriately low for the high level of assurance being provided. An auditor should select from all available procedures (that is, procedures that assess inherent, control, and fraud risk and restrict detection risk)—any combination that can limit audit risk to such an appropriately low level.

6.42 For regulatory requirements, the auditor's procedures may include reviewing reports of significant examinations and related communications between regulatory agencies and the entity and, when appropriate, making inquiries of the regulatory agencies, including inquiries about examinations in progress.

Audit Objectives

6.43 As noted in paragraph 6.22, the *Compliance Supplement* contains the audit objectives for each type of compliance requirement that the auditor should consider in planning and performing tests of compliance requirements. The audit objectives are useful in understanding the specific objectives to be satisfied when the auditor performs audit tests and determines whether the noncompliance that is identified is material.

Suggested Audit Procedures

6.44 The *Compliance Supplement* contains suggested audit procedures for testing federal programs for compliance. These suggested audit procedures represent procedures that may be used by the auditor in developing an audit program. The suggested audit procedures may also be useful in testing the same types of compliance requirements for programs that are not included in the *Compliance Supplement*. These suggested audit procedures represent a tool available to the auditor; however, the auditor is neither required to follow these audit procedures nor restricted to using only these procedures. The auditor should use professional judgment in determining the appropriate audit procedures to be performed to allow him or her to obtain sufficient evidence to form an opinion on the auditee's compliance with the compliance requirements that could have a direct and material effect on each major program.

Audit Sampling

6.45 The auditor generally uses audit sampling to obtain evidential matter. There are two approaches to audit sampling: nonstatistical and statistical. Circular A-133 does not require any particular sampling approach in a single audit. The factors to be considered in planning, designing, and evaluating audit samples (including planning a particular sample for a test of controls) are discussed in SAS No. 39, *Audit Sampling* (AICPA, *Professional Standards*, vol. 1, AU sec. 350). When planning to test a particular sample of transactions,

the auditor should consider the specific audit objective to be achieved and should determine that the audit procedure, or combination of procedures, to be applied will achieve that objective. The size of a sample necessary to provide sufficient evidential matter depends on both the objectives and the efficiency of the sample. Auditors should note that SAS No. 74, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance*, and Circular A-133 require the auditor to determine both the known questioned costs and likely questioned costs associated with audit findings. The determination of likely questioned costs may require the projection of sample results to determine whether a finding is required to be reported in the schedule of findings and questioned costs. Circular A-133 does not require the auditor to report an exact amount or a statistical projection of likely questioned costs, but rather to include an audit finding when the auditor's estimate of likely questioned costs is greater than \$10,000. See paragraph 6.59 for a further discussion of likely questioned costs.

6.46 The AICPA Auditing Practice Release *Audit Sampling* provides guidance to help auditors apply audit sampling in accordance with SAS No. 39. In the Auditing Practice Release, sampling in compliance tests of internal controls and in substantive tests of details, as well as dual-purpose testing is discussed.

Using Separate Samples for Each Major Program

6.47 Although the auditor must obtain sufficient evidence to support an opinion on compliance for each major federal program, separate samples for each major program are not required. Experience has shown, however, that it is preferable to select separate samples from each major program because the separate sample provides clear evidence of the tests performed, the results of those tests, and the conclusions reached. If the auditor chooses to select audit samples from the entire universe of major program transactions, the working papers should be presented in such a fashion that they clearly indicate that the results of such samples, together with other audit evidence, are sufficient to support the opinion on each major program's compliance. As noted in paragraph 6.37, the auditor should be aware that a sample of a few items with a low dollar value and from a large population, generally does not, by itself, provide sufficient evidence.

Consideration of Subsequent Events

6.48 The auditor's consideration of subsequent events in a compliance audit is similar to the auditor's consideration of subsequent events in a financial statement audit, as outlined in SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). The auditor should consider information about events relating to the applicable compliance requirements that comes to his or her attention after the end of the audit period and prior to the issuance of his or her report.

6.49 Two types of subsequent events require consideration by management and evaluation by the auditor. The first type consists of events that provide additional information about the entity's compliance during the audit period. For the period from the end of the audit period to the date of the auditor's report, the auditor should perform procedures to identify such events. These procedures should include, but may not be limited to, inquiries about and consideration of the following information:

- Relevant internal auditors' reports issued during the subsequent period

- Other auditors' reports identifying noncompliance that were issued during the subsequent period
- Regulatory agencies' reports on the entity's noncompliance that were issued during the subsequent period
- Information about the entity's noncompliance, obtained through other professional engagements for that entity

6.50 The second type of subsequent events consists of noncompliance that occurs subsequent to the audit period but before the date of the auditor's report. The auditor has no responsibility to detect such noncompliance. However, should such noncompliance come to the auditor's attention, it may be of such a nature and significance that the auditor should consider whether the matter is adequately disclosed in the notes to the schedule of expenditures of federal awards.

Evaluation and Reporting of Noncompliance

Instances of Noncompliance (Findings)

6.51 The auditor's tests of compliance with compliance requirements may disclose instances of noncompliance. Circular A-133 refers to these instances of noncompliance as "findings." Such findings may be of a monetary nature and involve questioned costs or may be nonmonetary and not result in questioned costs. Both *Government Auditing Standards* and Circular A-133 specify how certain findings should be reported. The auditor's opinion on compliance and his or her responsibilities for reporting findings are discussed in greater detail in chapter 10.

Compliance Opinion

6.52 Circular A-133 requires the auditor to report on compliance, which includes an opinion or disclaimer of opinion (on each major program) on whether the auditee complied with the applicable compliance requirements, and to prepare a schedule of findings and questioned costs (see paragraphs 10.41 through 10.46 and 10.55 through 10.67 for a further discussion). In evaluating whether the auditee complied with the compliance requirements in all material respects, the auditor should consider (a) the nature and frequency of the noncompliance identified, and (b) whether such noncompliance is material relative to the nature of the compliance requirements. Assessing materiality at the appropriate level is critical to the proper evaluation of findings. Materiality as it relates to giving an opinion on the auditee's compliance is discussed in paragraphs 6.13 through 6.16. The auditor's evaluation of the effect of questioned costs on the compliance opinion is discussed in paragraph 6.55.

Financial Statement Impact

6.53 The auditor also has the responsibility of assessing the impact of the actual and projected error noted in the single audit against the materiality level established for the basic financial statements (see paragraph 6.16). The auditor should consider the effect of (a) any contingent liability that may arise from the noncompliance in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and (b) for nongovernmental entities, any uncertainty regarding the resolution of instances of noncompliance in accordance with SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

Questioned Costs

6.54 Questioned costs are defined by Circular A-133 to include costs that are questioned by the auditor because of an audit finding (a) that resulted from a violation or possible violation of a provision of a law, regulation contract, grant, cooperative agreement, or other agreement or document governing the use of federal funds, including funds used to match federal funds, (b) for which the costs, at the time of the audit, are not supported by adequate documentation, or (c) for which the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Evaluating the Effect of Questioned Costs on the Compliance Opinion

6.55 In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of the total costs questioned for each major program (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). There may be instances in which the known questioned costs are not considered material but the likely questioned costs are considered material. In this situation, the auditor should consider the noncompliance to be material or may expand the scope of the audit and apply additional audit procedures to further establish the likely questioned costs. For example, if an auditor's sample results in known questioned costs related to three sample items out of thirty selected, the three errors may not be considered material. However, the auditor's projection of those errors to the entire population may suggest that there are likely questioned costs that are material. In this example, the auditor should consider the noncompliance to be material and should report a finding or expand the scope of the audit and apply additional audit procedures.

Federal Agency Consideration of Findings and Questioned Costs

6.56 The auditor's designation of a cost as questioned does not necessarily mean that a federal grantor agency will disallow the cost. In most instances, the auditor is unable to determine whether a federal awarding agency or pass-through entity will ultimately disallow a questioned cost, because the agency or entity has considerable discretion in these matters.

6.57 Circular A-133 defines a management decision as the evaluation by the federal awarding agency or pass-through entity of the audit findings and corrective action plan (see paragraphs 2.26 and 10.68 through 10.70 for a further discussion of the corrective action plan) and the issuance of a written decision as to what corrective action is necessary. Circular A-133 allows a federal awarding agency or pass-through entity receiving an auditor's report indicating findings and questioned costs six months after receipt of the audit report to issue such a decision. The nature of the questioned costs, as well as the amounts involved, are considered by the awarding agency or pass-through entity in issuing a management decision and deciding whether to disallow them. In addition, most federal awarding agencies have established appeal and adjudication procedures for questioned costs. Because of the discretion allowed in resolving these matters, all questioned costs are subject to uncertainty regarding their resolution.

Reporting the Findings

6.58 Circular A-133 requires the auditor to consider a different level of materiality for the purposes of reporting audit findings (see paragraphs 3.44

through 3.47 for a further discussion). Circular A-133 requires the auditor, in addition to providing an opinion on compliance, to include the following items, among other things, in the schedule of findings and questioned costs (see paragraph 10.56 for a complete listing of the items that are required to be included):

- Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material for 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 *Compliance Supplement*.
- Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program (see paragraph 6.22 for a listing of the fourteen types of compliance requirements). Known questioned costs are those specifically identified by the auditor.
- Known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement.
- Known questioned costs that are greater than \$10,000 for a federal program that is not audited as a major program (see paragraph 10.63 for a further discussion).

The reporting of findings is discussed in greater detail in paragraphs 10.63 and 10.64.

Reporting the Likely Questioned Costs

6.59 As noted before, in evaluating the effect of questioned costs on the opinion on compliance, the auditor considers both known questioned costs and the best estimate of the total costs questioned (likely questioned costs) for each major program. Known and likely questioned costs also need to be considered when audit findings are reported. In addition to reporting known questioned costs greater than \$10,000 in the schedule of findings and questioned costs, the auditor is also required to report known questioned costs when likely questioned costs are greater than \$10,000. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, the auditor estimates that the total questioned costs are in the \$50,000–\$60,000 range, the auditor would report a finding that indicates the known questioned costs of \$7,000. See paragraph 10.63 for a further discussion.

Findings That Cannot Be Quantified

6.60 The auditor may discover instances of noncompliance that cannot be quantified. The auditor's responsibility for reporting such findings can best be described through an example. Assume that the auditor encounters a pass-through entity that consistently fails to provide its subrecipients with federal award information. Circular A-133 requires the auditor to consider all findings in relation to a type of compliance requirement (in the example provided, subrecipient monitoring is the relevant type of compliance requirement) or an audit objective identified in the *Compliance Supplement*. The pertinent audit objective included in the *Compliance Supplement* and relating to the example provided here is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the

subrecipient.” Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance would be material in relation to the audit objective and, therefore, should be reported as an audit finding. In addition, the auditor should also consider whether reportable conditions exist and require reporting with respect to subrecipient monitoring.

Performing Follow-Up Procedures

Auditee Responsibilities for Audit Follow-Up and for the Summary Schedule of Prior Audit Findings

6.61 Circular A-133 states that the auditee is responsible for follow-up and corrective action on all audit findings. The follow-up required by Circular A-133 is facilitated by the requirement that the auditee prepare a summary schedule of prior audit findings (see paragraphs 2.21 and 10.68). This schedule reports the status of all audit findings included in the prior audit’s schedule of findings and questioned costs relative to federal awards. It also includes audit findings reported in the prior audit’s summary schedule of prior audit findings that were not identified as either (1) fully corrected, (2) no longer valid, or (3) not warranting further actions. Circular A-133 states that a valid reason for considering an audit finding as not warranting further action is that *all* of the following have occurred:

- Two years have passed since the audit report in which the finding occurred was submitted to the federal clearinghouse.
- The federal agency or pass-through entity is not currently following up with the auditee on the audit finding.
- A management decision was not issued.

6.62 Circular A-133 also states the following with regard to the auditee’s schedule of prior audit findings:

- When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
- When audit findings were not fully corrected or were only partially corrected, the summary schedule must describe the planned corrective action as well as any partial corrective action taken.
- When the corrective action taken is significantly different from the corrective action previously reported in a corrective action plan or in the federal agency’s or pass-through entity’s management decision, the summary schedule must provide an explanation.
- When the auditee believes the audit findings are no longer valid or do not warrant further actions, the reasons for this position must be described in the summary schedule (see paragraph 6.61).

Auditor Responsibilities for Follow-Up on Previously Reported Findings

6.63 Circular A-133 requires the auditor to follow up on prior audit findings, perform procedures to assess the reasonableness of the schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor should also perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year. The auditor’s reporting responsibilities are further discussed in chapter 10.

Auditor Follow-Up Procedures

6.64 To follow up on previous audit findings, the auditor should obtain the auditee's summary schedule of prior audit findings and should review its contents with appropriate members of management. Although in many cases the procedures performed in the current audit will provide a basis for the auditor to assess the schedule, the auditor may find it necessary to perform procedures directed specifically at the status of prior audit findings. In these cases, the following procedures are to be considered:

- Inquiry of auditee management and program personnel
- Review of management decisions issued by federal awarding agencies or pass-through entities to the auditee (see paragraph 6.57)
- Observation of an activity that has been redesigned to address a prior-year finding
- Testing of similar current-year transactions

Audit Follow-Up for Findings Reported, as Required by Government Auditing Standards

6.65 As noted in paragraph 3.16, *Government Auditing Standards* establishes an additional fieldwork standard, which requires the auditor to follow up on known material findings and recommendations from previous audits that could affect the financial statement audit to determine whether the auditee has taken timely and appropriate corrective actions. The auditee's schedule of prior audit findings is only required to include the status of prior-year findings relative to federal awards. However, there may be certain financial statement audit findings required to be reported under *Government Auditing Standards* that are included in the summary schedule of prior audit findings (because they also relate to federal awards). Also, although not required, some auditees may decide to include the status of other financial statement audit findings (that is, those that are not related to federal awards) in the schedule. For those financial statement audit findings included in the summary schedule of prior audit findings, the auditor's assessment of the reasonableness of the schedule (described in paragraphs 6.63 and 6.64) would meet the audit follow-up requirements of *Government Auditing Standards*. For financial statement audit findings that are not included in the schedule, the auditor should follow up on the findings to determine their status. See paragraph 10.62 for a discussion of the auditor's responsibility to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit.

Corrective Action Plan

6.66 Circular A-133 also requires that upon completion of the audit, the auditee prepare a corrective action plan that identifies the contact person responsible for corrective action, indicates the corrective action planned, the anticipated completion date or, if the auditee does not agree with the finding, an explanation and specific reasons why the auditee disagrees. The auditor may find the auditee's corrective action plan useful in performing audit follow-up (in addition to the auditee's summary schedule of prior audit findings) because it may provide a preliminary indication of the corrective steps planned by the auditee.

Disputes or Unresolved Findings

6.67 There may be times when, as part of the follow-up on prior findings, the auditor determines that (a) a previous finding is the subject of a dispute

between the auditee and the federal awarding agency or pass-through entity or (b) the federal awarding agency or pass-through entity has not addressed the finding by issuing a management decision. In these situations, if the finding relates to a current-year major program, the auditor should report similar transactions of the current year as findings and questioned costs until either the dispute is resolved or the initial finding no longer warrants further action under Circular A-133 as described in paragraph 6.61. However, if the auditor no longer believes that there is noncompliance because of additional evidence obtained in the current year, similar transactions need not be reported as findings.

Management Representations Related to Federal Awards

6.68 As part of an audit under Circular A-133, the auditor should obtain written representations from management about matters related to federal awards. Therefore, in addition to the management representations obtained in connection with an audit of the financial statements as discussed in paragraph 4.40, the auditor should obtain written representations from management concerning the identification and completeness of federal award programs, representations concerning compliance with compliance requirements, and identification of known instances of noncompliance.

Suggested Representations

6.69 The auditor should consider obtaining the following written representations in a single audit:²

- Management is responsible for complying, and has complied, with the requirements of Circular A-133.
- Management has prepared the schedule of expenditures of federal awards in accordance with Circular A-133 and has included expenditures made during the period being audited for all awards provided by federal agencies in the form of grants, federal cost-reimbursement contracts, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance.
- Management is responsible for complying with the requirements of laws, regulations, and the provisions of contracts and grant agreements related to each of its federal programs.
- Management is responsible for establishing and maintaining effective internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on its federal programs.
- Management has identified and disclosed to the auditor the requirements of laws, regulations and the provisions of contracts and grant agreements that are considered to have a direct and material effect on each federal program.

² These representations may be added to a representation letter obtained in connection with an audit of the financial statements instead of a separate letter.

- Management has made available all contracts and grant agreements (including amendments, if any) and any other correspondence that have taken place with federal agencies or pass-through entities and are related to federal programs.
- Management has complied, in all material respects, with the compliance requirements in connection with federal awards except as disclosed to the auditor.
- Management has identified and disclosed to the auditor all amounts questioned and any known noncompliance with the requirements of federal awards, including the results of other audits or program reviews.
- Management's interpretations of any compliance requirements that have varying interpretations have been provided.
- Management has made available all documentation related to the compliance requirements, including information related to federal program financial reports and claims for advances and reimbursements.
- Federal program financial reports and claims for advances and reimbursements are supported by the books and records from which the basic financial statements have been prepared, and are prepared on a basis consistent with that presented in the schedule of expenditures of federal awards.
- The copies of federal program financial reports provided to the auditor are true copies of the reports submitted, or electronically transmitted, to the federal agency or pass-through entity, as applicable.
- If applicable, management has monitored subrecipients to determine that they have expended pass-through assistance in accordance with applicable laws and regulations and has met the requirements of Circular A-133.
- If applicable, management has issued management decisions on a timely basis after their receipt of subrecipients' auditor's reports that identified noncompliance with laws, regulations, or the provisions of contracts or grant agreements, and has ensured that subrecipients have taken the appropriate and timely corrective action on findings.
- If applicable, management has considered the results of subrecipient audits and has made any necessary adjustments to their own books and records.
- Management is responsible for and has accurately prepared the summary schedule of prior audit findings to include all findings required to be included by Circular A-133.
- Management has provided the auditor with all information on the status of the follow-up on prior audit findings by federal awarding agencies and pass-through entities, including all management decisions.
- Management has accurately completed the appropriate sections of the data collection form.
- If applicable, management has disclosed all contracts or other agreements with the service organizations.

- If applicable, management has disclosed to the auditor all communications from the service organization relating to noncompliance at the service organization.
- Management has disclosed any known noncompliance occurring subsequent to the period for which compliance is audited.
- Management has disclosed whether any changes in internal control over compliance or other factors that might significantly affect internal control, including any corrective action taken by management with regard to reportable conditions (including material weaknesses), have occurred subsequent to the date as of which compliance is audited.

Refusal to Furnish Written Representation

6.70 Management's refusal to furnish all written representations that the auditor considers necessary in the circumstances constitutes a limitation on the scope of the audit sufficient to require a qualified opinion or disclaimer of opinion on the auditee's compliance with major program requirements. The auditor should also consider the effects of management's refusal on his or her ability to rely on other management representations.

State and Local Government Compliance Auditing Considerations

6.71 An auditor may also be engaged to test and report on compliance with state and local laws and regulations in addition to the testing and reporting requirements imposed by *Government Auditing Standards* and Circular A-133. Although such auditing is outside the scope of this SOP, such a requirement may specify compliance tests, similar to those in a single audit. When this is the case, auditors should consult state or local government officials or other sources concerning the nature and scope of the required testing. However, state or local government funds should be distinguished from pass-through federal funds. When a single audit is conducted, pass-through federal funds are considered part of the federal awards received. See paragraphs 3.57 through 3.61 for a brief discussion of state and local compliance requirements.

Chapter 7

DETERMINATION OF MAJOR PROGRAMS

7.1 As noted in paragraph 2.22, Circular A-133 requires the auditee to identify in its accounts all federal awards received and expended and the federal programs under which they were received. The auditee is also required to prepare a schedule of expenditures of federal awards for the period covered by its financial statements (see chapter 5 for a further discussion of the requirements related to this schedule). However, Circular A-133 places the responsibility for identifying major programs on the auditor, and it provides the criteria to be used in applying a risk-based approach to determining major programs. The risk-based approach is designed to focus the single audit on higher-risk programs. See paragraph 7.20 for a description of when the auditor can deviate from the use of risk criteria.

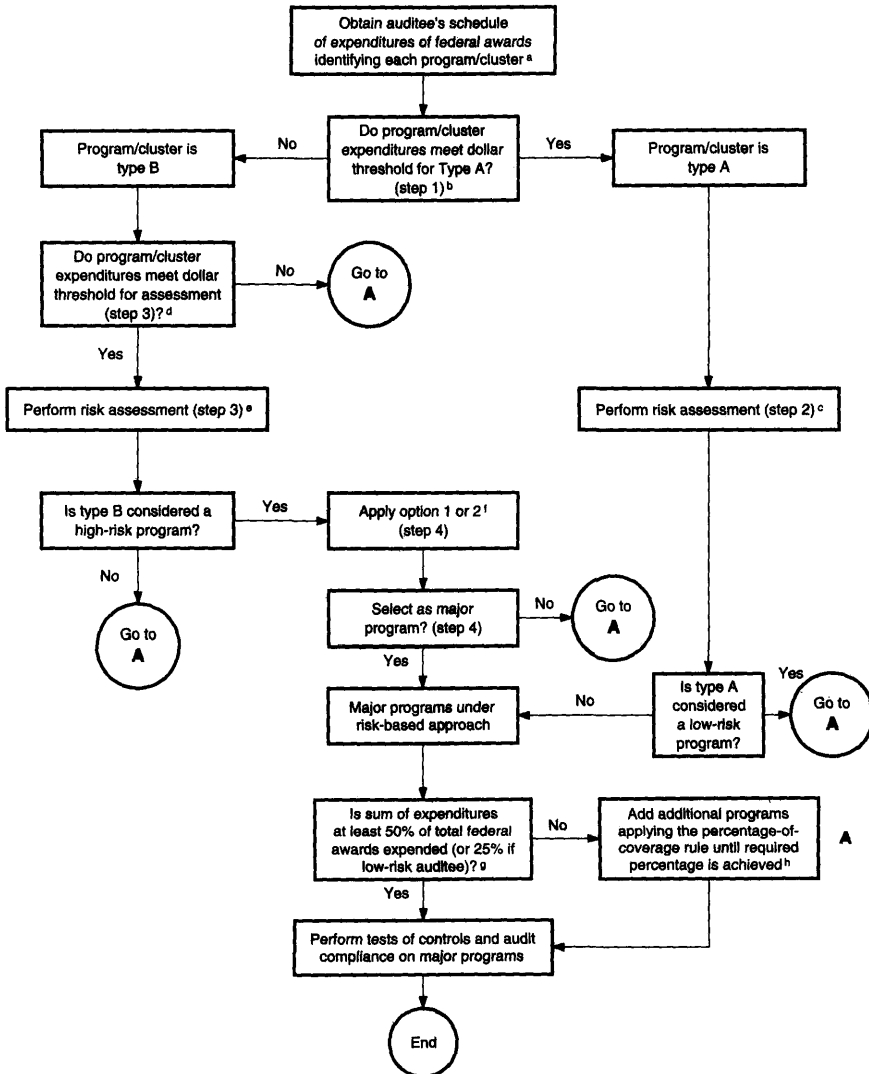
7.2 The auditor's determination of the programs to be audited is based on an evaluation of the risk of noncompliance occurring that could be material to an individual major federal program. In evaluating such risk, the auditor considers, among other things, the current and prior audit experience with the auditee, the oversight exercised by federal agencies and pass-through entities, and the inherent risk of the federal programs. The auditor should use professional judgment and the guidance in sections 520, 525, and 530 of Circular A-133 in the risk assessment process. In addition, the auditor should consider the need to discuss the nature of federal programs with the management of the auditee and of the federal or state agency that provided the funds to the auditee.

Applying the Risk-Based Approach

7.3 The guidance on the risk-based approach is organized here as provided in Circular A-133 and consists of the following steps (see table 7.1 for a flowchart illustration of applying the risk-based approach for determining major programs):

- Step 1—determination of type A and type B programs (paragraphs 7.4 through 7.9)
- Step 2—identification of low-risk type A programs (paragraphs 7.10 through 7.13)
- Step 3—identification of high-risk type B programs (paragraphs 7.14 through 7.16)
- Step 4—determination of programs to be audited as major (paragraphs 7.17 through 7.20)

Flowchart Illustration of Applying the Risk-Based Approach for Determining Major Programs



- a. See paragraph 1.18 for the definition of federal programs, including clusters.
- b. See paragraphs 7.4 through 7.9 for a detailed discussion of step 1.
- c. See paragraphs 7.10 through 7.13 for a detailed discussion of step 2.
- d. See paragraphs 7.14 through 7.16 for a detailed discussion of step 3.
- e. Before performing the risk assessment, the auditor should consider whether option 1 or option 2 will be selected under step 4 because it will affect whether risk assessments need to be performed on all type B programs or only some type B programs. See paragraph 7.15.
- f. The number of type B high-risk programs identified as major programs is either—
 - *Option 1:* one-half of the number of type B high-risk programs, unless this number exceeds the number of low-risk type A programs identified in step 2. In this case, the auditor would be required to audit as major the same number of high-risk type B programs as low-risk type A programs. Under this option, the auditor is expected to perform risk assessments on all type B programs that exceed the threshold for type B.
 - *Option 2:* one high-risk program for each low-risk type A program. This option does not require the auditor to perform risk assessments on all type B programs. See paragraphs 7.17 through 7.20 for a detailed discussion of step 4, including option 1 and option 2.
- g. There may be instances when the auditee includes certain noncash assistance (such as loan guarantees or loans) in the notes to the schedule of expenditures of federal awards (see paragraph 5.13). The auditor should be sure to include such noncash assistance as part of total federal awards expended when performing this calculation.
- h. The additional programs/clusters selected (marked “A” on the flow-chart) to meet the percentage-of-coverage rule are audited as major programs in addition to type A and type B programs identified in steps 1 through 4. See paragraph 7.24 for a further discussion of the percentage-of-coverage rule.

Step 1—Determination of Type A and Type B Programs

7.4 To determine which federal programs are to be audited as major (see step 4), the auditor must first identify federal programs as being either type A or type B as defined in Circular A-133. In general, type A programs are larger federal programs and type B programs are smaller federal programs. The auditor should obtain the schedule of expenditures of federal awards from the auditee to assist in the identification of type A and type B programs. The schedule of expenditures of federal awards, prepared by the auditee, includes all cash and noncash awards either on the face of the schedule or in the notes to the schedule. Auditors should note that for purposes of determining major programs, a cluster of programs should be considered as one program (see paragraphs 1.18, 1.19, 2.18, 5.6, and 8.30 for a further discussion of a cluster of programs).

Type A Program Criteria

7.5 The larger federal programs are labeled as type A. The criteria that Circular A-133 establishes for identifying Type A programs are presented in table 7.1.

Table 7.1**Criteria for Identifying Type A Programs**

<i>When Total Federal Awards Expended* Are—</i>	<i>A Type A Program Is Any Program With Federal Awards Expended That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to, \$100 million	\$300,000 or 3% (0.03) of federal awards expended
More than \$100 million and less than or equal to \$10 billion	\$3 million or 0.3% (0.003) of federal awards expended
More than \$10 billion	\$30 million or 0.15% (0.0015) of federal awards expended

* Includes both cash and noncash awards.

Type B Program Criteria

7.6 Federal programs that do not meet the type A criteria are considered type B programs.

Effect of Large Loans and Loan Guarantees on Identification of Type A Programs

7.7 The various types of noncash awards, including loans and loan guarantees, and how they are valued are discussed in chapter 5. Circular A-133 states that when the auditor applies the dollar criteria shown in table 7.1 to identify type A programs, the inclusion of large loans and loan guarantees should not result in the exclusion of other federal programs as type A programs. Auditors should note that this requirement relates only to loans and loan guarantees and not to any other large noncash awards. When a federal program providing loans or loan guarantees *significantly affects* the number or size of type A programs, the auditor should consider the loan or loan guarantee program a type A program and exclude its values in determining other type A programs. The auditor should use professional judgment in determining whether type A programs would be *significantly affected* in this situation.

7.8 The example in table 7.2 demonstrates this concept by showing the identification of type A programs as well as the effect of loans and loan guarantees on that identification process.

Table 7.2**Identification of Type A Programs and the Effect of Loans and Loan Guarantees**

<i>Program / Federal Grantor</i>	<i>Federal Awards Expended (\$000)</i>
Cash program A—U.S. Department of Labor	\$ 1,335
Cash program B—U.S. Department of Health and Human Services	3,000
Cash program C-1—U.S. Department of Education	175
Cash program C-2—U.S. Department of Education	280
Cash program D—U.S. Department of Housing and Urban Development (a pass-through grant from a local government)	310
Subtotal—cash federal awards expended	\$ 5,100
Commodities program E—U.S. Department of Agriculture (a pass-through grant from a state)	2,000
Subtotal—cash and commodities federal awards expended	\$ 7,100
Loan program F—U.S. Department of Housing and Urban Development	33,500*
Loan guarantee program G—U.S. Department of Agriculture	57,000*
Total federal awards expended	\$97,600

* In accordance with Circular A-133, loans and loan guarantees include new loans made during the year, plus prior-year loans for which the federal government imposes continuing compliance requirements, plus any interest subsidy, cash, or administrative cost allowance received. See paragraphs 5.14 and 5.15 for additional information.

7.9 In table 7.2 the auditee has \$97,600,000 in total federal awards expended. Therefore, an application of the criteria in table 7.1 would indicate that type A programs would be those that expended federal awards equal to or greater than \$2,928,000 (3 percent of \$97,600,000), or programs B, F, and G. However, when large loan and loan guarantee programs F and G are excluded from the base amount of the total federal awards expended in the calculation, the type A programs would be those programs that expended federal awards equal to or greater than \$300,000 (the larger of \$213,000 [3 percent of \$7,100,000], or \$300,000). Therefore, under the second calculation programs A, B, D, E, F, and G would be type A programs. If the auditor, in his or her professional judgment, concludes that the difference in the number or size of type A programs is significantly affected by the inclusion of the loans and loan guarantees (which in this example would be likely due to the significant increase in type A programs), the auditor would identify programs A, B, D, E, F, and G as type A programs. The auditor should consider contacting the cognizant or oversight agency for audit if the auditor is unsure about whether to exclude loan or loan guarantees when determining type A programs.

Step 2—Identification of Low-Risk Type A Programs

7.10 After completing step 1, the auditor should perform a risk assessment of each type A program to identify those that are low-risk. Circular A-133 includes certain conditions that, when met, indicate that a type A program may be low-risk.

General Conditions for Low-Risk Type A Programs

7.11 Type A programs may generally be considered low-risk if both of the following conditions are met: (a) the program has been audited as a major program

in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and (b) in the most recent audit period, the *program* had no audit findings (see paragraph 10.63 for a description of audit findings).

Auditor Judgment in Determination of Low-Risk Type A Programs

7.12 Circular A-133 permits the auditor to conclude, based on professional judgment, that a type A program is low-risk even though (a) in the prior audit period it may have had known or likely questioned costs greater than \$10,000 for a type of compliance requirement, (b) known fraud has been identified, or (c) the summary schedule of prior audit findings materially misrepresents the status of a prior audit finding. For example, consider a situation in which the funds expended under a federal program in the prior year totaled \$10 million, there were known questioned costs of \$11,000 that related to one isolated instance, and there were no additional likely questioned costs. In this example, the auditor, based on professional judgment, could decide that the program is low-risk in the current year. In making the final determination of whether a type A program is low-risk, the auditor should also consider the risk criteria in paragraphs 7.26 through 7.36, the results of audit follow-up, and whether any changes in the personnel or systems affecting a type A program have significantly increased its risk. Based on all of this information, the auditor would apply professional judgment in determining whether a type A program is low-risk.

Type A Program Not Considered Low-Risk at Request of Federal Awarding Agency

7.13 A federal awarding agency may request that a type A program for certain recipients not be considered low-risk so that it would be audited as a major program. For example, it may be necessary for a large type A program to be audited as major each year for particular recipients, to allow the federal agency to comply with the Government Management Reform Act of 1994. In this instance, Circular A-133 requires the federal awarding agency to obtain approval from the OMB. Furthermore, the federal awarding agency must notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year end to be audited. (See also paragraph 7.35 for a discussion of the federal agency or pass-through entity option to identify federal programs as higher risk in the *Compliance Supplement*.)

Step 3—Identification of High-Risk Type B Programs

7.14 After completing steps 1 and 2, the auditor should identify type B programs that are high-risk, using professional judgment and the risk criteria discussed in paragraphs 7.26 through 7.36. Except for known reportable conditions in internal control or instances of noncompliance, a single risk criteria would, in general, seldom cause a type B program to be considered high-risk.

7.15 Before beginning step 3, the auditor should—

- a. Consider whether there are low-risk type A programs. When there are no type A programs identified as low-risk (either because there are no type A programs or because none of the type A programs are low-risk), the auditor is not required to perform step 3. Instead, the auditor would audit as major enough type B programs to meet the

percentage-of-coverage rule (see paragraph 7.24). When there are type A programs, but none are low-risk, the auditor would audit as major all type A programs plus any additional type B programs needed to meet the percentage-of-coverage rule. In either case, any programs requested to be audited by a federal agency or pass-through entity must be audited as a major program and would be included in determining whether the percentage-of-coverage rule has been met (see paragraph 7.21).

- b. Consider whether option 1 or option 2 will be used in step 4 (see paragraphs 7.18 through 7.19 for a detailed description of each option). The auditor's decision of which option to choose will likely be based on audit efficiency and will affect how many type B programs are subject to risk assessment. The auditor should consider the following discussion before deciding whether to use option 1 or option 2.
- Under option 1, the auditor is required to perform a risk assessment on all type B programs (excluding small type B programs as discussed in paragraph 7.16). In comparison with option 2, option 1 will likely require the auditor to perform more type B program risk assessments, but may also result in the auditor having to audit fewer major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Also assume that the auditor chooses option 1. In this scenario, the auditor would be required to perform a risk assessment on all type B programs. If the auditor finds that only four type B programs are high-risk, the auditor would only be required to audit two of the four high-risk type B programs as major (one-half of the number of high-risk type B programs).
 - Under option 2, the auditor is only required to identify high-risk type B programs up to the number of low-risk type A programs. In comparison with option 1, option 2 will likely require the auditor to perform fewer type B risk assessments, but may also result in the auditor having to audit more major programs. For example, assume that an auditee has four low-risk type A programs and ten type B programs that exceed the amount specified in table 7.3. Assume also that the first four type B programs subject to risk assessment are determined by the auditor to be high-risk. In this scenario, the auditor may choose option 2, identify the four high-risk type B programs as major, and not perform risk assessments on the remaining six type B programs. Using the same example but assuming that the auditee only has one low-risk type A program (instead of four), the auditor would be required to audit one type B program as major under either option 1 or 2. In this scenario, option 2 would likely be the most efficient choice for the auditor since the auditor would only need to perform type B program risk assessments until one high-risk type B program was identified (under option 1 the auditor would be required to perform a risk assessment on all type B programs).

Criteria for Performing Risk Assessments on Type B Programs

7.16 An auditor is not expected to perform risk assessments on relatively small federal programs. Therefore, Circular A-133 only requires the auditor to

perform risk assessments on type B programs that exceed the larger of the criteria shown in table 7.3.

Table 7.3

Criteria for Performing Risk Assessments on Type B Programs

<i>When Total Federal Awards Expended* Are—</i>	<i>Perform Risk Assessment for Type B Programs That Exceed the Larger of—</i>
More than or equal to \$300,000 and less than or equal to \$100 million	\$100,000 or 0.3% (0.003) of federal awards expended
More than \$100 million	\$300,000 or 0.03% (0.0003) of federal awards expended

* Includes both cash and noncash awards.

Step 4—Determination of Programs to Be Audited as Major

Criteria for Major Programs

7.17 After completing steps 1 through 3, the auditor identifies the major programs. At a minimum, Circular A-133 requires the auditor to audit all of the following as major programs:

- All type A programs, except those identified as low-risk under step 2 (see paragraphs 7.10 through 7.13)
- High-risk type B programs as identified under either of the two options described in paragraph 7.18
- Programs to be audited as major based on a federal agency request (in lieu of the federal agency conducting or arranging for additional audits; see paragraph 7.21 for further information)
- Additional programs, if any, that are necessary to meet the percentage-of-coverage rule described in paragraph 7.24

Two Options Available for Identifying High-Risk Type B Programs

7.18 Section 520(e)(2) of Circular A-133 provides two options for identifying high-risk type B programs:

- *Option 1.* Under option 1, the auditor is expected to perform risk assessments of all type B programs that exceed the amount specified in table 7.3, and to audit at least one-half of the high-risk type B programs as major, unless this number exceeds the number of low-risk type A programs identified in step 2 (that is, the cap). In this case, the auditor would be required to audit as major the same number of high-risk type B programs as the cap. For example, consider an auditee that has ten low-risk type A programs, and fifty type B programs above the amount specified in table 7.3. Under this option, the auditor would be required to perform risk assessments of the fifty type B programs. Assume that based on that assessment, the auditor determines that there are twenty-five high-risk type B programs. One-half of the twenty-five high-risk type B programs is 12.5, which rounds up to thirteen programs. Under this option, the auditor would audit thirteen of the high-risk type B programs as major; however, since the cap in this example is ten (that is, the number of low-risk type

A programs), the auditor is only required to audit ten high-risk type B programs as major.

- *Option 2.* Under option 2, the auditor is only required to audit as major one high-risk type B program for each type A program identified as low-risk in step 2. Under this option the auditor would not be required to perform risk assessments for any type B program when there are no low-risk type A programs (that is, the cap is zero). Continuing with the previous example, under option 2 the auditor would perform risk assessments of type B programs until ten high-risk programs are identified (that is, ten is the number of low-risk type A programs). The auditor would then audit as major the ten type B programs identified as high-risk. Depending on the order in which risk assessments on type B programs are performed, the auditor might only need to perform risk assessments of ten type B programs determined to be high-risk, or the auditor may need to perform risk assessments on additional Type B programs until ten high-risk programs are identified.

7.19 The auditor may choose option 1 or option 2. There is no requirement to justify the reasons for selecting either option. The results under options 1 and 2 may vary significantly, depending on the number of low-risk type A programs and high-risk type B programs (see paragraph 7.15). Circular A-133 encourages the auditor to use an approach that provides an opportunity for different high-risk type B programs to be audited as major over a period of time.

Deviation From Use of Risk Criteria

7.20 For first-year audits, Circular A-133 allows auditors to deviate from the above-described risk assessment process. A first-year audit is defined as the first year an entity is audited under the June 30, 1997, revision to Circular A-133 or as the first year of a change in auditors. This exception allows the auditor to elect to determine major programs as all type A programs plus any type B programs as are necessary to meet the percentage-of-coverage rule described in paragraph 7.24. Under this option, the auditor is not required to perform steps 2, 3, and 4. However, to ensure that a frequent change of auditors would not preclude the audit of high-risk type B programs, this election for first-year audits may not be used more than once every three years. Auditors should consider whether this exception is an option during the planning phase of the single audit (see also paragraphs 3.33 and 3.34 for a discussion of initial-year audit considerations).

Other Considerations Regarding the Risk-Based Approach

Federal Agency Requests for Additional Major Programs

7.21 A federal agency may request an auditee to have a particular federal program audited as a major program in lieu of the federal agency conducting or arranging for additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such a request by informing the federal agency whether the program would otherwise be audited as a major program using the risk-based approach and, if it would not,

informing the agency of the estimated incremental cost. The federal agency must then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based on the federal agency's request, and the federal agency agrees to pay the full incremental costs, then the auditee must have the program audited as a major program. This approach may also be used by pass-through entities for a subrecipient.

Documentation of Risk Assessment in the Working Papers

7.22 Circular A-133 requires the auditor to document in the working papers the risk assessment process used in determining major programs. It is therefore necessary for the auditor to document adequately, as required by GAAS and *Government Auditing Standards*, the determination of major programs (see the discussion of working paper requirements in paragraphs 3.20 through 3.22 and 3.27 through 3.28).

Auditor Judgment in the Risk Assessment Process

7.23 Circular A-133 states that when the determination of major programs is performed and documented by the auditor in accordance with the circular, the auditor's judgment in applying the risk-based approach to determine major programs is presumed correct. Challenges by federal agencies and pass-through entities should only be made for clearly improper use of the guidance in Circular A-133. It should be noted, however, that federal agencies and pass-through entities may provide the auditor with guidance about the risk of a particular federal program, which the auditor should consider when determining major programs.

Percentage-of-Coverage Rule

7.24 Circular A-133 requires the auditor to audit, as major programs, federal programs with federal awards expended that, in the aggregate, encompass at least 50 percent of the total federal awards expended. However, if the auditee meets the criteria for a low-risk auditee (see paragraph 7.25), the auditor is only required to audit as major programs federal programs with federal awards expended that, in the aggregate, encompass at least 25 percent of the total federal awards expended. To comply with this requirement, the auditor should compute the total federal awards expended for the major programs, determined under step 4, as a percentage of the total federal awards expended. If the total does not equal 50 percent (or 25 percent in the case of a low-risk auditee) of the total federal awards expended, the auditor should select additional programs (either type A or type B) to equal 50 percent (or 25 percent in the case of a low-risk auditee) and test them as major programs. The selection of additional programs to meet the percentage of coverage is based on the auditor's professional judgment. When selecting additional programs to meet the percentage-of-coverage rule, the auditor may select programs without regard to risk assessment. If loans or loan guarantees are major programs, these programs may be used for purposes of meeting the percentage-of-coverage rule. Furthermore, when a federal agency or pass-through entity requests and pays for a program to be audited as major (see paragraph 7.21), that program may also be used for purposes of meeting the percentage-of-coverage rule.

Low-Risk Auditee Criteria

7.25 Circular A-133 establishes certain conditions for determining whether an auditee is low-risk. An auditee that meets all of the following con-

ditions for each of the preceding two years (or in the case of biennial audits, the preceding two audit periods) qualifies as a low-risk auditee and is eligible for the reduced audit coverage discussed in paragraph 7.24:

- a. Single audits were performed on an annual basis in accordance with Circular A-133. An auditee that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- b. The auditor's opinions on the financial statements and the schedule of expenditures of federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of federal awards and may provide a waiver.
- c. There were no deficiencies in internal control over financial reporting that were identified as material weaknesses under the requirements of *Government Auditing Standards*. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of federal awards and may provide a waiver.
- d. None of the federal programs had audit findings from any of the following in either of the preceding two years (or in the case of biennial audits, the preceding two audit periods) in which they were classified as type A programs:
 - Material weaknesses in the internal control over compliance
 - Noncompliance with the provisions of laws, regulations, contracts, or grant agreements that have a material effect on the type A program
 - Known or likely questioned costs that exceed 5 percent of the total federal awards expended for a type A program during the year

Criteria for Federal Program Risk

7.26 The auditor's risk assessment should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the federal program being evaluated. Circular A-133 indicates that the auditor should use professional judgment and consider certain criteria to identify risk in federal programs. As a part of the risk assessment, the auditor may also wish to discuss a particular federal program with auditee management and with the federal agency or pass-through entity. The criteria for federal program risk that are identified in Circular A-133 are discussed in the following sections.

Current and Prior Audit Experience

7.27 The auditor should consider his or her prior experience with the auditee and the results of audits performed in the past. The following specific factors that should be considered:

- Weaknesses in the internal control over compliance for federal programs (paragraph 7.28)
- Federal programs administered under multiple internal control structures (paragraph 7.29)

- A weak system for monitoring subrecipients when significant parts of federal programs are passed through to subrecipients (paragraph 7.30)
- The extent to which computer processing is used (paragraph 7.31)
- Prior audit findings (paragraph 7.32)
- Federal programs not recently audited as major (paragraph 7.33)

Weaknesses in Internal Control Over Federal Programs

7.28 In assessing program risk, the auditor should consider internal control over compliance for federal programs (see chapter 8 for detailed guidance on internal control over compliance for federal programs). Weak internal control over compliance for federal programs is an indication of higher risk. Consideration should also be given to the control environment over federal programs and to such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements. The auditor may also consider the competence and experience of the personnel who administer federal programs. In instances in which the staff are new or do not have experience with a program, consideration should be given to assessing the program at a higher level of risk.

Federal Programs Administered Under Multiple Internal Control Structures

7.29 Federal programs administered by multiple internal control structures may have a higher risk. This often occurs when multiple operating units are involved in the administration of federal programs. An example of this would be a university that has several campuses administering a federal program. When assessing risk, the auditor should consider whether any internal control weaknesses are isolated in a single operating unit (that is, one college campus) or are pervasive throughout the entity. If the identified weaknesses are isolated, and absent other weaknesses, the auditor could still potentially reach the conclusion that the program is low-risk. The final determination would be based on the auditor's judgment.

Weak System for Monitoring Subrecipients

7.30 Consideration should be given to the extent that federal programs are passed through to subrecipients. If the auditee passes a significant portion of a federal program to subrecipients and the auditor has identified that the auditee has a weak system for monitoring subrecipients, the auditor should consider assigning a higher risk to the program. Alternatively, if the auditee passes a significant portion of programs to subrecipients and the auditee has an effective system in place to monitor the subrecipients, the auditor should consider assigning a lower level of risk to the program.

Extent to Which Computer Processing Is Used

7.31 When assessing risk, the auditor should consider the extent to which computer processing is used to administer federal programs, as well as the complexity of that processing. A complex system does not always indicate higher risk. On the other hand, a newly installed system that has not been tested in the past, or a recently modified system, may indicate higher risk. Auditors should refer to SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to SAS No. 31, Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec.

326), for guidance when significant auditee information is transmitted, processed, maintained, or accessed electronically.

Prior Audit Findings

7.32 As a part of the risk assessment, the auditor should consider prior audit findings. These findings may be the result of previous single audits by independent auditors or of compliance or financial audits performed by internal auditors or government auditors in conjunction with the federal awarding agency's monitoring activities. The auditor should consider assessing a higher risk for programs for which prior audit findings have a significant impact on a federal program or for which no corrective action has been implemented since the findings were identified.

Federal Programs Not Recently Audited as Major

7.33 Federal programs that have not recently been audited as major programs may be of higher risk than federal programs recently audited as major. For example, many type B programs may never have been audited as major programs in the past. A higher level of risk would likely be assessed on such programs than on those programs that have been consistently audited as major programs without audit findings.

Oversight Exercised by Federal Agencies and Pass-Through Entities

7.34 The oversight exercised by federal agencies or pass-through entities could indicate risk. An important factor in assessing risk is the results of recent audits performed by federal agencies or pass-through entities. For example, recent monitoring or other reviews that were performed by an oversight entity and that disclosed no audit findings may indicate lower risk, whereas monitoring that disclosed significant findings could indicate higher risk. However, the auditor should understand the scope of the review that was performed. Reviews performed by federal agencies or pass-through entities vary widely as to coverage and intensity.

7.35 Circular A-133 states that federal agencies, with the concurrence of the OMB, may identify federal programs that are high-risk. This identification will be provided by the OMB in the *Compliance Supplement*. For example, the U.S. Department of Health and Human Services has identified the Medicaid Assistance Program as a program of higher risk in the *Compliance Supplement*. Although such an identification by a federal agency does not preclude an auditor from determining that a program is low-risk (for example, because prior audits have shown strong internal control and compliance), the auditor should consider it as part of the risk assessment process.

Inherent Risk of the Federal Programs

7.36 As part of the risk assessment, the auditor needs to consider the inherent risk of federal programs. Inherent risk is the risk that material noncompliance with requirements applicable to a major program could occur, assuming there is no related internal control. Programs with higher inherent risk may be of a higher risk for the purpose of determining major programs. Circular A-133 provides examples of program characteristics with potentially higher inherent risks; these are discussed in paragraphs 6.8 and 6.9.

Chapter 8

CONSIDERATION OF INTERNAL CONTROL OVER COMPLIANCE FOR MAJOR PROGRAMS

8.1 Circular A-133 establishes requirements for additional audit procedures and reporting relative to the auditor's consideration of internal control over compliance for major programs. These requirements are beyond those of a financial statement audit conducted in accordance with GAAS and *Government Auditing Standards*. The auditor's consideration of internal control over financial reporting is discussed in chapter 4. In this chapter, the additional considerations of internal control over compliance for major programs are discussed. The reporting on internal control over compliance for major programs is discussed in paragraph 8.3 and chapter 10.

Summary of Circular A-133 Requirements Related to Internal Control Over Compliance for Federal Programs

Auditee Responsibilities

8.2 Circular A-133 requires the auditee to maintain internal control over compliance for federal programs that provides reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs.

Auditor Responsibilities

8.3 In addition to the requirements of GAAS and *Government Auditing Standards*, Circular A-133 requires the auditor to—

- Perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs.
- Plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program.
- Perform testing of the internal control over compliance as planned.
- Report on internal control over compliance describing the scope of the testing of internal control and the results of the tests and, where applicable, referring to the separate schedule of findings and questioned costs. This schedule includes, where applicable, a statement that reportable conditions in internal control over compliance for major programs were disclosed by the audit and whether any such conditions were material weaknesses.

Auditor Responsibility for Internal Control Over Compliance for Programs That Are Not Major

8.4 The auditor has no responsibility under Circular A-133 to obtain an understanding of internal control over compliance for programs that are not considered major, or to plan or perform any related testing of internal control over compliance for those programs except for any procedures the auditor may choose to perform as part of the risk assessment process in determining major programs (see chapter 7). However, the auditor should note that a program that is not considered major could still be material to the financial statements. In this situation, in conjunction with the financial statement audit, the auditor may need to obtain an understanding of the internal control over financial reporting that is relative to the program. The auditor's consideration of internal control over financial reporting is discussed in chapter 4.

Circular A-133 Definition of Internal Control Over Federal Programs

8.5 Circular A-133 defines internal control over federal programs as follows.

Internal control pertaining to the compliance requirements for federal programs (*Internal control over federal programs*) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for federal programs:

1. Transactions are properly recorded and accounted for to:
 - a. Permit the preparation of reliable financial statements and federal reports;
 - b. Maintain accountability over assets; and
 - c. Demonstrate compliance with laws, regulations, and other compliance requirements;
2. Transactions are executed in compliance with:
 - a. Laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on a federal program; and
 - b. Any other laws and regulations that are identified in the compliance supplement; and
3. Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Control Objectives

8.6 SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*, states that there are three categories of internal control: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. These distinct but somewhat overlapping categories have differing purposes and allow a directed focus to meet the needs of the auditee and others

regarding each separate purpose. For purposes of this SOP, controls relevant to the audit of the financial statements are referred to as “internal control over financial reporting” and are encompassed in the report on internal control over financial reporting that is required by *Government Auditing Standards* (see paragraphs 10.38 through 10.40). Controls relevant to an audit of compliance with requirements applicable to major federal programs are referred to collectively in this SOP “as internal control over compliance” and are encompassed in the report on internal control over compliance required by Circular A-133 (see paragraphs 10.46 through 10.49). See paragraphs 4.11 and 4.12 for a more detailed discussion.

Auditor’s Consideration of Internal Control Over Compliance for Each Major Program

8.7 The auditor’s consideration of internal control over compliance for each major program is similar to the consideration of internal control over financial reporting in a financial statement audit as described in SAS No. 55, as amended by SAS No. 78. In his or her consideration of internal control over compliance, the auditor—

- Obtains an understanding of internal control over compliance for federal programs that is sufficient to plan the audit, by performing procedures to understand (a) the design of controls relevant to the compliance requirements for each major program and (b) whether they have been placed in operation (note that although Circular A-133 requires the auditor to perform procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs, it does not actually require the achievement of a low assessed level of control risk).
- Assesses control risk for the assertions relevant to the compliance requirements for each major program. The auditor uses the knowledge provided by the understanding of internal control over compliance and the assessed level of control risk to determine the nature, timing, and extent of substantive tests for assertions relevant to the compliance requirements for each major program. Compliance auditing is discussed in chapter 6.

8.8 An understanding of the internal control over compliance and an assessment of control risk may be performed concurrently in an audit. Similarly, based on the assessed level of control risk that the auditor expects to support and on audit efficiency considerations, the auditor often plans to perform some tests of controls concurrently with obtaining an understanding of controls.

Obtaining an Understanding of Internal Control Over Compliance for Major Programs

Understanding Compliance Assertions and Identifying Relevant Controls

8.9 As noted in paragraph 8.3, the auditor is required to perform procedures to obtain an understanding of internal control over compliance for fed-

eral programs that is sufficient to plan the audit to support a low assessed level of control risk for major programs. The determination of major programs is discussed in chapter 7. The auditor needs to understand the assertions relevant to the compliance requirements for each major program. Those assertions will determine the types of controls the auditor needs to consider in a single audit. In identifying controls relevant to specific assertions, the auditor should consider that the controls can have either a pervasive effect on many assertions or a specific effect on an individual assertion depending on the nature of the particular internal control component involved. An entity generally also has controls relating to objectives that are not relevant to specific assertions and that therefore need not be considered in a Circular A-133 audit.

8.10 In obtaining an understanding of controls, the auditor should consider the guidance in paragraphs 41 through 43 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.41–43). This includes performing procedures to provide sufficient knowledge of both the design of the relevant controls pertaining to each of the five internal control components (that is, control environment, risk assessment, control activities, information and communication, and monitoring) and whether they have been placed in operation. The auditor ordinarily obtains this knowledge through previous experience with the entity and through such procedures as inquiries of appropriate management, supervisory, and staff personnel; an inspection of the entity's documents and records; and his or her observation of the entity's activities and operations. The nature and extent of the procedures performed generally vary from entity to entity and are influenced by the size and complexity of the entity, the auditor's previous experience with the entity, the nature of the particular control, and the nature of the entity's documentation of specific controls.

8.11 Entities may use the same controls for more than one federal program and for similar transactions (for example, cash disbursements). Accordingly, those controls will often provide assurance regarding the achievement of the compliance objectives related to some or all federal program transactions and assets.

OMB Compliance Supplement Internal Control Guidance

8.12 When determining the assertions relevant to the compliance requirements for each major program of the entity, the auditor should consider referring to the discussion on internal control found in part 6 of the *Compliance Supplement*. The *Compliance Supplement* provides a general discussion of the control objectives, components, and activities that are likely to apply to the fourteen types of compliance requirements (see the discussion of the types of compliance requirements in paragraph 6.22). This guidance is not a checklist of required internal control characteristics; it is intended, instead, to assist the auditor in planning and performing the single audit. However, the auditee is responsible for designing and implementing internal control that is sufficient to provide reasonable assurance that the auditee is managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its federal programs. Control activities beyond those discussed in the *Compliance Supplement* may need to be designed and implemented by the auditee to meet this responsibility. Similarly, the auditor is responsible for evaluating internal control over compliance, to plan the audit to support a low assessed level of control risk for each major program. The auditor may need to perform tests of internal control

over compliance that are related to control objectives and activities in addition to those discussed in the *Compliance Supplement*.

Multiple-Component Considerations

8.13 Federal programs are often administered by several organizational components within an auditee. Each component may maintain separate internal control over compliance that is relevant to the programs, or parts of the programs, that the component administers. In these situations, the auditor should perform procedures to obtain an understanding of the internal control over compliance that is separately maintained by organizational components and that is relevant to each material part of a major program, and should plan and perform testing of those controls as discussed in this chapter (see also paragraphs 6.34 and 7.29 for other multiple-component considerations).

Subrecipient Considerations

8.14 Many entities that are pass-through entities for federal awards make subcontract or subgrant awards and disburse their own funds, as well as federal funds, to subrecipients. The auditor of the pass-through entity has certain considerations related to the entity's internal control over the monitoring of subrecipients. See paragraph 9.23 for a discussion of the audit considerations of federal pass-through awards.

Planning and Performing Testing of Internal Control Over Compliance for Major Programs

Assessing Control Risk

8.15 After obtaining an understanding of internal control over compliance for major programs, the auditor makes a preliminary assessment of control risk for the assertions relevant to the compliance requirements for each major program (see also the related discussion in paragraphs 6.7 through 6.12). Control risk is the risk that material noncompliance that could occur in a major program will not be prevented or detected on a timely basis by the auditee's internal control over compliance. The assessment of control risk is the process of evaluating the effectiveness of an entity's internal control over compliance in preventing or detecting material noncompliance with the compliance requirements for each major program. In assessing control risk, the auditor should consider the guidance in paragraphs 45 through 57 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU secs. 319.45–57). The auditor should consider the preliminary assessment of control risk when he or she designs the nature and extent of tests of compliance. The Circular A-133 requirement to plan the testing of internal control over compliance to support a low assessed level of control risk is discussed in paragraphs 8.16 through 8.19. The auditor's responsibilities when the internal control over compliance is ineffective in preventing or detecting noncompliance are discussed in paragraphs 8.20 through 8.22.

Planning the Testing of Internal Control Over Compliance for Major Programs to Support a Low Assessed Level of Control Risk

8.16 Circular A-133 requires the auditor to plan the testing of internal control over compliance for major programs to support a low assessed level of

control risk for the assertions relevant to the compliance requirements for each major program. Professional standards do not define or quantify a low assessed level of control risk. A low assessed level of control risk can only be understood in relative terms when it is compared with maximum or moderate levels. Therefore, the auditor exercises professional judgment to determine the procedures necessary to obtain a low level of control risk. The auditor should consider the purpose of the requirement to plan the tests of controls to achieve a low assessed level of control risk (that is, federal agencies want to know if conditions indicate that auditees have not implemented adequate internal control over compliance for federal programs to ensure compliance with applicable laws and regulations).

8.17 Assessing control risk at below the maximum level involves (a) identifying specific controls relevant to specific assertions that are likely to prevent or detect material misstatements in those assertions and (b) performing tests of controls to evaluate the effectiveness of such controls.

8.18 When the auditor assesses control risk at below the maximum level, the auditor should obtain sufficient evidential matter to support that assessed level of control risk. The type of evidential matter, its source, its timeliness, and the existence of other evidential matter related to the conclusions to which it leads all bear on the degree of assurance the evidential matter provides. In obtaining evidential matter, the auditor should consider the guidance in paragraphs 64 through 78 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU secs. 319.64–78).

8.19 Paragraph 4.32 of *Government Auditing Standards* provides the following additional guidance related to the assessment of control risk:

- The lower the auditors' assessment of control risk, the more evidence they need to support that assessment.
- Auditors may have to use a combination of different kinds of tests of controls to get sufficient evidence of a control's effectiveness.
- Inquiries alone generally will not support an assessment that control risk is below the maximum.
- Observations provide evidence about a control's effectiveness only at the time observed; they do not provide evidence about its effectiveness during the rest of the period under audit.
- Auditors can use evidence from tests of controls done in prior audits (or at an interim date), but they have to obtain evidence about the nature and extent of significant changes in policies, procedures, and personnel since they last performed those tests.

Existence of Ineffective Internal Control in Preventing or Detecting Noncompliance

8.20 When internal control over compliance for some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the auditor is not required to plan and perform tests of internal control over compliance as described in paragraphs 8.3, 8.16, and 8.23. If the internal control over compliance is deemed likely to be ineffective, Circular A-133 requires the auditor to assess control risk at the maximum and consider whether any additional compliance tests are required because of

ineffective internal control. The auditor is also required to report a reportable condition (including whether such condition is a material weakness) as part of the audit findings (see paragraphs 10.46, 10.56, and 10.63 for a discussion of how reportable conditions should be reported).

8.21 The assessment of the effectiveness of internal control over compliance in preventing or detecting noncompliance is determined in relation to each individual type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. For example, controls over requirements for eligibility may be ineffective because of a lack of segregation of duties. In this case, the auditor would be required to—

- Report the lack of segregation of incompatible duties as it relates to eligibility as a reportable condition (note that the reportable condition could be a material weakness).
- Assess the control risk related to requirements for eligibility at the maximum.
- Consider the lack of effective control when designing the nature, timing, and extent of procedures designed to test compliance with requirements for eligibility of the major program. In most cases, the extent of testing would need to be expanded.

8.22 In planning the tests of controls, the auditor will need to consider the results of tests performed in prior years. If the results of the prior year tests of controls prevented a low level of control risk assessment, the auditor may consider expanded testing in the next audit period. That consideration should include the testing of any changes in internal control over compliance that were intended to eliminate deficiencies noted in the previous year. If, however, the auditee has made no changes to its internal control over compliance, the auditor may determine that controls are not likely to be effective and may choose not to plan and perform tests of controls. In this situation, a reportable condition should be reported (see paragraph 8.20).

Performing Tests to Evaluate the Effectiveness of Controls

8.23 As noted in paragraph 8.3, Circular A-133 requires the auditor to perform testing of internal control over compliance as planned (see paragraphs 8.20 through 8.22 for an exception related to ineffective internal control over compliance). Tests of controls should include the types of procedures described in paragraphs 34 and 35 of SAS No. 55, as amended by SAS No. 78 (AICPA, *Professional Standards*, vol. 1, AU sec. 319.52 and 319.53). Tests of controls, which are directed toward either the effectiveness of the design or the operation of a control, may include such steps as (a) inquiries of appropriate personnel, including grant and contract managers; (b) the inspection of documents and reports; (c) the observation of the application of the specific controls; and (d) the reperformance of the application of the controls by the auditor. The auditor should perform such procedures (unless control is likely to be ineffective) regardless of whether he or she would otherwise choose to obtain evidence to support an assessment of control risk below the maximum level.

Evaluating the Results of Tests of Controls

8.24 If, when evaluating the results of tests of controls, the auditor is not able to support a low assessed level of control risk for major programs, the au-

ditor is not required to expand his or her testing of internal control over compliance. The auditor may choose not to perform further tests. In this situation, the auditor would assess control risk at other than low, design tests of compliance accordingly, and consider the need to report an audit finding (see paragraph 10.63). In general, a reportable condition or a material weakness will need to be reported. Similarly, the auditor may decide to expand the testing of internal control over compliance, but that decision would be based on whether the auditor considered expanded internal control testing to be more efficient than additional tests of compliance. The auditor should consider whether, based on the testing performed, control risk can be assessed at below the maximum to reduce substantive tests of compliance. If it cannot, the auditor should assess control risk at the maximum level.

Reportable Conditions and Material Weaknesses Related to Federal Programs

8.25 For purposes of reporting on internal control over compliance for federal programs, the definitions of a reportable condition and a material weakness, which are similar to those in SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, are as follows:

- A *reportable condition* is a matter coming to the auditor's attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in the auditor's judgment, could adversely affect an entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants.
- A *material weakness* in internal control over compliance is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

8.26 In performing a single audit, the auditor should be aware that reportable conditions and material weaknesses are to be considered as they relate to a type of compliance requirement for each major program or to an audit objective identified in the *Compliance Supplement*. Furthermore, certain conditions may be reportable conditions for a major program and not be considered reportable conditions as they relate to the assertions of management in the financial statements.

Documentation Requirements

8.27 The auditor should document his or her understanding of the auditee's internal control components that was obtained to plan the audit, and should document the basis for his or her conclusions about the assessed level of control risk related to the internal control over compliance for major programs. If the auditor has not performed tests of controls relevant to certain requirements or programs, as discussed in paragraphs 8.20 through 8.22, then the rationale for omitting such tests should be documented.

8.28 As noted in paragraphs 3.20 through 3.22, *Government Auditing Standards* includes an additional standard that requires working papers to

contain sufficient information to enable an experienced auditor having no previous connection with the audit to ascertain from them the evidence that supports the auditor's significant conclusions and judgments.

8.29 The form and extent of this documentation is influenced by the size and complexity of the auditee, as well as the nature of the auditee's internal control over compliance. For example, the documentation of the understanding of internal control over compliance of a large, complex entity may include flowcharts, questionnaires, or decision tables. For a small entity, however, the documentation may be less extensive. In general, the more complex the internal control over compliance and the more extensive the procedures performed, the more extensive the auditor's documentation.

Program Cluster Considerations

8.30 An entity may have separate controls related to individual federal programs that are treated as one program "cluster" under a Circular A-133 audit (for example, SFA and R&D—see paragraphs 1.18, 1.19, 2.18, 5.6, and 7.4 for a discussion of program clusters). In this case, when evaluating whether an identified deficiency is a reportable condition, the auditor should consider the significance of the deficiency in relation to the overall major program (program cluster). Following are some examples:

- Significant deficiencies in specific controls over the time cards of college work-study students would likely be considered a reportable condition when college work-study program expenditures are significant in relation to SFA programs.
- Significant deficiencies in controls over a single campus or department of a university where a significant amount of research was administered would likely be a reportable condition when considered in relation to the total expenditures of R&D programs.
- A deficiency in an SFA or R&D program that was clearly insignificant to SFA or R&D, respectively, as a whole would not necessarily be considered a reportable condition.

Chapter 9

AUDIT CONSIDERATIONS OF FEDERAL PASS-THROUGH AWARDS

Introduction

9.1 Many nonfederal entities receiving federal awards make pass-through payments of federal awards to other entities that are considered subrecipients. The amount of those payments may be material to the pass-through entity's financial statements, individual major programs, or both. The auditor's consideration of pass-through federal awards in an audit of both pass-through entities and subrecipients of federal awards under Circular A-133 is discussed in this chapter. The auditee's and auditor's responsibilities with respect to activities carried out by vendors is also discussed in this chapter. An auditee with multiple federal funding agreements may be a pass-through entity in regard to some awards, a subrecipient in regard to other awards, and a vendor with respect to other agreements.

Definitions

9.2 Circular A-133 includes the following definitions that are relevant to pass-through awards:

- *Federal award*—federal financial assistance and federal cost-reimbursement contracts that nonfederal entities receive directly from federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors.
- *Nonfederal entity*—a state, local government, or non-profit organization (NPO).
- *Recipient*—a nonfederal entity that expends federal awards received directly from a federal awarding agency to carry out a federal program.
- *Pass-through entity*—a nonfederal entity that provides a federal award to a subrecipient to carry out a federal program.
- *Subrecipient*—a nonfederal entity that expends federal awards received from a pass-through entity to carry out a federal program but does not include an individual who is a beneficiary of such a program. A subrecipient may also be a recipient of other federal awards directly from a federal awarding agency.
- *Vendor*—a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the federal program.

Applicability of Circular A-133

9.3 Circular A-133 applies to both recipients expending federal awards received directly from federal awarding agencies and subrecipients expending federal awards received from a pass-through entity. Accordingly, both recipients and subrecipients that expend \$300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133 (see chapter 11 for a detailed discussion of program-specific audits).

9.4 The determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards passed through to subrecipients, the activity that requires the pass-through entity to comply with laws, regulations, and the provisions of contracts or grant agreements is the disbursement of funds to subrecipients. The activity that requires subrecipients to comply with laws, regulations, and the provisions of contracts or grant agreements is the expenditure of the pass-through award.

9.5 Payments received by a vendor for goods or services provided in connection with a federal program are not considered federal awards. Furthermore, Medicaid payments to a subrecipient for providing patient care services to Medicaid-eligible individuals are not considered federal awards expended under Circular A-133 unless a state requires the funds to be treated as federal awards expended because reimbursement is on a cost-reimbursement basis.

9.6 If a pass-through entity provides federal awards to subrecipients, the pass-through entity must monitor the subrecipients' activities to provide reasonable assurance that the subrecipients administer federal awards in compliance with federal requirements. As part of the compliance audit, the auditor of the pass-through entity must test and report on subrecipient monitoring (which is one of the fourteen types of compliance requirements in the *Compliance Supplement*—see paragraph 6.22) when federal awards passed through to subrecipients are material to a major program (see paragraphs 9.24 through 9.35). If the federal awards provided are immaterial or relate to a program that is not considered major, the auditor of the pass-through entity has no additional compliance auditing responsibilities related to the funds passed through to subrecipients.

9.7 Most of this chapter focuses on compliance auditing considerations for auditors of pass-through entities. However, paragraphs 9.43 through 9.47 provide additional considerations for auditors of subrecipients.

Pass-Through Entities, Subrecipients, and Vendors

Subrecipient Status Versus Vendor Status

9.8 The responsibilities for compliance with federal program requirements and the applicable compliance requirements to be tested by the auditor are significantly different for pass-through entities, subrecipients, and vendors. Guidance on distinguishing between a subrecipient and a vendor is provided in section 210 of Circular A-133 and is summarized in paragraphs 9.9 through 9.11.

Characteristics Indicative of a Federal Award Received by a Subrecipient

9.9 According to Circular A-133, characteristics indicative of a federal award received by a subrecipient are when the entity (see paragraph 9.12 for examples of the relationship between pass-through entities and subrecipients)—

- Determines who is eligible to receive what federal financial assistance.
- Has its performance measured against whether the objectives of the federal program are met.
- Has responsibility for programmatic decision making.
- Has responsibility for adherence to applicable federal program compliance requirements.
- Uses the federal funds to carry out a program of the entity as compared to providing goods or services for a program of the pass-through entity.

Characteristics Indicative of a Payment for Goods or Services Received by a Vendor

9.10 According to Circular A-133, the characteristics indicative of a payment for goods or services received by a vendor are when the entity (see paragraph 9.13 for examples of the relationship between recipients and vendors)—

- Provides the goods and services within normal business operations.
- Provides similar goods or services to many different purchasers.
- Operates in a competitive environment.
- Provides goods or services that are ancillary to the operation of the federal program.
- Is not subject to the compliance requirements of the federal program.

Use of Judgment in Determining Subrecipient or Vendor Status

9.11 Circular A-133 states that there may be unusual circumstances or exceptions to the listed characteristics in paragraphs 9.9 and 9.10. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present, and judgment should be used in determining whether an entity is a subrecipient or vendor. In some cases, it may be difficult to determine whether the relationship with the entity is that of a subrecipient or of a vendor. The federal cognizant agency for audit, the oversight agency for audit, or the federal awarding agency may be of assistance in making these determinations.

Description of Relationships

Pass-Through Entity and Subrecipient

9.12 Following are examples of a typical relationship between a pass-through entity and a subrecipient:

- A state department of education (pass-through entity) receives a federal award and is responsible for administering and disbursing the federal award to local school districts (subrecipients) according to a formula or some other basis.
- A regional planning commission (pass-through entity) receives a federal award for the feeding of elderly and low-income individuals, and the award is disbursed to NPOs (subrecipients) to support their feeding programs.

- A hospital (subrecipient) receives a federal award from a university (pass-through entity) to conduct research.
- A theater group (subrecipient) receives a federal award from a state arts commission (pass-through entity) to support a summer arts series.

Recipient and Vendor

9.13 Following are examples of a typical relationship between a recipient and a vendor:

- A local government (recipient) receives a federal award to provide mental health services in a designated area. Some of the funds are paid to a contractor (vendor) to repair a leaking roof.
- A county (recipient) receives a federal award to operate a Head Start program and pays a NPO (vendor) to provide temporary clerical services.
- An NPO (recipient) receives a federal award to run a preschool and pays a medical doctor (vendor) to perform health screening on a per-student basis.
- An NPO (recipient) receives a federal award to operate a child care center and pays a not-for-profit clinic (vendor) to perform physical exams.

Entity is Both a Subrecipient and a Pass-Through Entity

9.14 There are instances in which an entity can be both a subrecipient and a pass-through entity as shown in the following examples:

- A local government receives a pass-through federal award from a state government agency (the local government is a subrecipient) and further passes through a portion of the federal award to an NPO (the local government is also a pass-through entity) to administer a federal program.
- A not-for-profit area agency receives a pass-through federal award from a state (the not-for-profit area agency is a subrecipient) and further passes through a portion of the federal award to a for-profit health care provider (the not-for-profit area agency is also a pass-through entity). See paragraph 9.40 for a discussion of a pass-through entity's responsibilities when the subrecipient is a for-profit entity.

Vendor Compliance Considerations

Auditee's Responsibilities

9.15 Circular A-133 states that in most cases, the auditee's compliance responsibility for a vendor is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. A program's compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions that are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine compliance.

Auditor's Responsibilities

9.16 When vendors are responsible for program compliance, the auditor should determine whether vendor transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements if such transactions are material to a major program of the auditee. In such a case, the auditor would normally evaluate a vendor's compliance by reviewing the auditee's records and the results of the auditee's procedures for ensuring compliance by the vendor. When the auditor cannot obtain sufficient assurance from reviewing the auditee's records and procedures, the auditor should consider the need to report a reportable condition. The auditor will also ordinarily need to perform additional procedures to determine compliance. These procedures may include testing the vendor's records or obtaining reports on compliance procedures performed by the vendor's independent auditor.

9.17 Prior to performing a single or program-specific audit, it is important for the auditor to understand the nature of the auditee's vendor relationships, whether the vendors are responsible for program compliance, the auditee's procedures for ensuring vendor compliance, and whether it will be necessary for the auditor to test vendor records. The auditor should consider including such information in the communication used to establish an understanding with the auditee (see paragraphs 3.6 and 3.7). If subsequent to undertaking a single or program-specific audit the auditor becomes aware of a significant vendor relationship that will require the auditor to perform additional procedures on vendor records, the auditor should inform the auditee that the requirements of Circular A-133 will not be met unless additional procedures are performed. If the auditee or vendor precludes the auditor from performing such additional procedures, the auditor should qualify his or her opinion or disclaim an opinion because of a scope limitation (see paragraphs 10.43 through 10.45 for a further discussion of scope limitations).

Single Audit Considerations of Pass-Through Entities

9.18 The following matters are relevant to planning and conducting a single audit of a pass-through entity:

- Pass-through entity responsibilities (see paragraph 9.19)
- Audit planning considerations (see paragraphs 9.20 through 9.22)
- Consideration of internal control over compliance (see paragraph 9.23)
- Subrecipient monitoring (see paragraphs 9.24 through 9.35)
- Reporting considerations (see paragraphs 9.36 through 9.39)
- For-profit subrecipients (see paragraph 9.40)
- Non-U.S.-based entities (see paragraph 9.41)
- A state's designation of a cluster of programs (see paragraph 9.42)

Pass-Through Entity Responsibilities

9.19 A pass-through entity is responsible for ensuring that subrecipients expend awards in accordance with applicable laws, regulations, and provisions of contracts or grants. Circular A-133 requires a pass-through entity to perform the following for the federal awards it provides to subrecipients:

- Identify the federal awards made by informing each subrecipient of the CFDA title and number, the award's name and number, the award year, whether the award is for R&D, and the name of the federal agency. When some of this information is not available, the pass-through entity should provide the best information available to describe the federal award.
- Advise subrecipients of the requirements imposed on them by federal laws, regulations, and the provisions of contracts or grant agreements, as well as any supplemental requirements imposed by the pass-through entity.
- Monitor the activities of subrecipients as necessary to ensure that federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
- Ensure that subrecipients expending \$300,000 or more in federal awards during the subrecipient's fiscal year have met the audit requirements of Circular A-133 for that fiscal year.
- Issue management decisions on audit findings within six months after receipt of subrecipients' audit reports, and ensure that subrecipients take appropriate and timely corrective action.
- Consider whether subrecipient audits necessitate the adjustment of the pass-through entity's own records.
- Require subrecipients to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with Circular A-133.
- Keep subrecipients' report submissions (or other written notification when the subrecipient is not required to submit a reporting package) on the file for three years from the date of receipt (see paragraphs 9.47, 10.76, and 10.78).

Audit Planning Considerations

Impact of Pass-Through Federal Awards on the Determination of Major Programs

9.20 As noted in paragraph 9.4, the determination of when a federal award is expended is based on when the activity related to the award occurs. With respect to federal awards provided by a pass-through entity to subrecipients, the federal awards are deemed to be expended by the pass-through entity when the funds are disbursed to subrecipients, regardless of when subrecipients expend the federal funds. Accordingly, the amount of federal funds disbursed to subrecipients should be included in the total expenditures of federal awards of the pass-through entity and in the determination of the pass-through entity's major programs (see chapter 7 for a more detailed discussion of the determination of major programs).

Pass-Through Entity Request for a Program to Be Audited as a Major Program

9.21 When a subrecipient expends \$300,000 or more of federal awards, Circular A-133 permits the pass-through entity to request that the program be

audited as a major program in lieu of the pass-through entity conducting or arranging for additional audits. If the pass-through entity makes such a request, it is required to pay the full incremental cost for such an audit (see paragraph 2.19 for additional information).

Materiality

9.22 The auditor of the pass-through entity should compare the amount of federal funds passed through to subrecipients with the total expenditures for each individual major program or cluster to determine if the amount is material. The auditor's consideration of materiality is a matter of professional judgment and is influenced by the auditor's perception of the needs of a reasonable person who will rely upon the auditor's work. When the amount of federal funds passed through to subrecipients is material in relation to the major program being audited, the greater the need for the auditor to test the subrecipient-monitoring requirements. It should be noted that some federal programs are designed in such a manner that subrecipient expenditures are intended to be material to the pass-through entity's award. For example, the Community Services Block Grant requires a state to subgrant at least 90 percent of the state's award.

Consideration of Internal Control Over Compliance

9.23 As part of performing procedures to obtain an understanding of internal control over compliance for federal programs that is sufficient to plan the audit of the pass-through entity to support a low assessed level of control risk for major programs, the auditor should consider the pass-through entity's internal control over compliance used to monitor subrecipients (see chapter 8 for an additional discussion of considerations concerning internal control over compliance). Tests of internal control over compliance used to monitor subrecipients may include inquiry, observation and inspection of documentation, or a reperformance by the auditor of some or all of the monitoring procedures identified in paragraph 9.28. The nature and extent of the tests performed will vary depending on the auditor's assessment of inherent risk, understanding of the internal control over compliance, materiality, and professional judgment. Auditors should consider referring to part 6 of the *Compliance Supplement*, which describes (among other things) certain characteristics of internal control over compliance that, when present and operating effectively, may ensure compliance with program requirements for subrecipient monitoring. The results of the auditor's testing of internal control over compliance assist in determining the nature, timing, and extent of subrecipient monitoring compliance testing.

Subrecipient Monitoring

9.24 The Single Audit Act requires the pass-through entity to monitor subrecipients' use of federal awards through site visits, limited scope audits, or other means. Since the pass-through entity is held accountable for federal awards administered by their subrecipients, the pass-through entity needs to establish an appropriate subrecipient-monitoring process and to decide what, if any, additional monitoring procedures may be necessary to ensure the subrecipients' compliance. Arrangements for subrecipient monitoring should be made by the pass-through entity in its agreements with subrecipients.

9.25 Auditors must consider subrecipient monitoring in a compliance audit of an entity that disburses to subrecipients federal awards that are mater-

ial to a major program (see the discussion of materiality in paragraph 9.22). The auditor should consider whether the pass-through entity monitors subrecipients and has established internal control over compliance that provides reasonable assurance that subrecipients are managing federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of the pass-through entity's major programs.

Compliance Supplement Guidance

9.26 One of the fourteen types of compliance requirements included in the *Compliance Supplement* is subrecipient monitoring. The *Compliance Supplement* identifies several audit objectives for subrecipient monitoring. According to the *Compliance Supplement*, in a single audit of a pass-through entity, the auditor should determine whether the pass-through entity—

- Identified the federal award's information and compliance requirements to the subrecipient.
- Monitored the subrecipient's activities to provide reasonable assurance that the subrecipient administered federal awards in compliance with federal requirements.
- Ensured that the required audits were performed, and required appropriate corrective action concerning monitoring and audit findings.
- Evaluated the impact of subrecipient activities on the pass-through entity.

9.27 The *Compliance Supplement* also identifies the suggested audit procedures for testing the compliance audit objectives for pass-through entities (see paragraph 6.44 for a further discussion of suggested audit procedures). The auditor may consider coordinating the subrecipient-related tests performed as part of activities allowed or unallowed (tests that subrecipient agreements were for allowable activities), cash management (tests of cash reports submitted by subrecipients), eligibility (tests that subawards were made only to eligible subrecipients), and procurement (tests of suspension and debarment certifications) with the tests of subrecipient monitoring.

Pass-Through Entity Monitoring Procedures

9.28 The monitoring procedures used by the pass-through entity may include on-site visits, reviews of documentation supporting requests for reimbursement, and limited-scope audits. Section 230(b)(2) of Circular A-133 defines limited-scope audits as agreed-upon procedures engagements that are conducted in accordance with either GAAS or the AICPA attestation standards, and that are paid for and arranged by a pass-through entity and only address one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and reporting. Following are other monitoring procedures that a pass-through entity may perform:

- Reviewing grant applications submitted by subrecipients to determine that—
 - Applications are filed and approved in a timely manner
 - Each application contains the condition that the subrecipient comply with the federal requirements set by the federal agency

- Establishing internal control over compliance to provide reasonable assurance that—
 - Funds are disbursed to subrecipients only on an as-needed basis
 - Funds are disbursed to subrecipients only on the basis of approved, properly completed reports submitted on a timely basis
 - Refunds that are due from subrecipients are billed and collected in a timely manner
 - Subrecipients and other entities and individuals receiving federal funds meet eligibility requirements
- Reviewing financial and technical reports received from subrecipients on a timely basis and investigating unusual items
- Reviewing subrecipient audit reports, to evaluate them for completeness and for compliance with applicable laws and regulations
- Evaluating audit findings; issuing appropriate management decisions, if necessary; and determining if an acceptable plan for corrective action has been prepared and implemented
- Reviewing previously detected deficiencies and determining that corrective action was taken

Monitoring When the Subrecipient Has a Single or Program-Specific Audit

9.29 As noted in paragraph 9.3, subrecipients that expend \$300,000 or more in federal awards are required to have a single or program-specific audit in accordance with Circular A-133. If subrecipients have a single or program-specific audit, the pass-through entity's receipt and review of the results of that audit and its action on related findings may be sufficient to meet the subrecipient-monitoring requirements of Circular A-133. However, it is more likely that the receipt and review of such audit results should be merely one tool that should be used by the pass-through entity as part of a comprehensive subrecipient-monitoring process. Pass-through entities should be aware that a single audit is likely to provide varying degrees of assurance concerning a particular program. For example, a pass-through award may not have been tested as a major program as part of a subrecipient's audit. For this reason, the pass-through entity should consider the testing and results of the single audit of the subrecipient to determine what effect those results should have on other monitoring procedures employed by the pass-through entity.

9.30 In many cases, the pass-through entity will not have received all the subrecipient audit reports covering the time period being audited at the pass-through entity in time to incorporate the results into its own audit. The reports for the pass-through entity and the subrecipient are not required to be issued simultaneously, but the pass-through entity is required to have internal control over compliance in place, to determine that subrecipient audit reports have been received and that corrective action is taken after the receipt of the subrecipient's audit. If the subrecipient's audit report is current, it need not cover the same period as the pass-through entity's audit. If the pass-through entity has an effective system for monitoring subrecipients, its auditor should be able to rely on the subrecipient's audit cycle, even if it is not coterminous with the pass-through recipient's fiscal year.

Considering Risk Factors When Developing Monitoring Procedures

9.31 The preamble to Circular A-133 states that the OMB expects pass-through entities to consider various risk factors (such as the relative size and

complexity of the federal awards administered by subrecipients, the entity's prior experience with each subrecipient, and the cost-effectiveness of various monitoring procedures) in developing subrecipient-monitoring procedures. For example, if a pass-through entity provides a large percentage of the only federal award it expends to ten subrecipients that each expend less than \$300,000 in federal awards annually, the pass-through entity should carefully consider the most cost-effective method of monitoring these federal awards. Perhaps the majority of this federal award is provided to two subrecipients. The pass-through entity might consider conducting site visits at these two subrecipients and simply reviewing the documentation supporting requests for reimbursement from the other eight subrecipients. Conversely, if a small percentage of a federal award is provided to subrecipients that each expend less than \$300,000 in federal awards, the risk to the pass-through entity is most likely low and, therefore, the monitoring procedures could be minimal.

Unallowable Audit Costs

9.32 For subrecipients that expend less than \$300,000 in federal awards annually, the cost of any audits or attestation engagements (other than the limited-scope audits paid for and arranged by a pass-through entity as described in paragraph 9.28), are not allowable costs and, therefore, cannot be charged to any federal award. Accordingly, Circular A-133 would prohibit the cost of a financial statement audit conducted in accordance with GAAS or *Government Auditing Standards* from being charged (by either a pass-through entity or subrecipient) to federal awards of a subrecipient that expends less than \$300,000 in federal awards annually. The allowability of audit costs is discussed in greater detail in paragraph 2.12.

When the Subrecipient Monitoring System Is Not Sufficient

9.33 The auditor may determine that the pass-through entity's subrecipient-monitoring system is not sufficient to ensure subrecipient's compliance with laws, regulations, and the provisions of grants and contracts. In this situation, the auditor should report a reportable condition (and possibly a material weakness) and consider whether the insufficient monitoring system represents an instance of noncompliance that should be reported as a compliance finding. The effect of the noncompliance on the opinion on compliance for major programs is primarily a function of the pervasiveness of the lack of monitoring and the materiality of subrecipient funding to a program. For example, if the pass-through entity did not perform subrecipient-monitoring procedures and 90 percent of the program was passed through to subrecipients, an opinion modification would likely be warranted. This would likely be the case even if the scope of the audit was expanded to include additional audit procedures to determine that the subrecipients actually complied with laws and regulations.

9.34 There may be instances in which the pass-through entity asks the auditor to perform additional procedures to determine the compliance of a subrecipient (such as conducting tests of records at the subrecipient's site). This would be considered an expansion of the scope of the audit. The auditor should be aware that such an expansion of the scope of the audit would not be sufficient to remedy the reportable condition (or material weakness) and, if applicable, noncompliance of the pass-through entity's monitoring system. However, an expansion of the scope of the audit may remedy the noncompliance related to the type of compliance requirement being tested (for example, eligibility).

9.35 The auditor should also consider any implications of an insufficient subrecipient-monitoring system on the opinion on the financial statements. If amounts passed through to subrecipients are considered material to the financial statements of the pass-through entity, the auditor should determine whether the report on the financial statements should be modified. Before making this determination, the auditor should take into consideration any evidential matter that may be available to the auditor (such as subrecipients' Circular A-133 audit reports and other financial reports that may have been submitted to the pass-through entity) that could indicate that the subrecipients administered the program in compliance with laws and regulations. Further, the auditor should also consider whether it is necessary to report an internal control or compliance finding in the report issued to meet the requirements of *Government Auditing Standards*.

Reporting Considerations

Schedule of Expenditures of Federal Awards

9.36 Circular A-133 states that, to the extent practical, pass-through entities should identify in the schedule of expenditures of federal awards the total amount provided to subrecipients from each federal program (see chapter 5 for an additional discussion of the schedule). If a pass-through entity is unable to identify amounts provided to subrecipients, the auditor should consider whether a reportable condition (and possibly a material weakness) should be reported. The auditor should also consider whether material non-compliance (for subrecipient monitoring) that is required to be reported as an audit finding has occurred.

Evaluation of Audit Findings

9.37 Circular A-133 requires the auditor to consider a finding in relation to the type of compliance requirement (subrecipient monitoring, in this case) or an audit objective identified in the *Compliance Supplement*, whether or not the finding can be quantified. For example, the auditor may discover that a pass-through entity consistently failed to provide its subrecipients with federal award information, including applicable compliance requirements. The pertinent audit objective included in the *Compliance Supplement* and relating to this example is for the auditor to "determine whether the pass-through entity identifies federal award information and compliance requirements to the subrecipient." Because the pass-through entity failed to provide federal award information to its subrecipients, this noncompliance is material in relation to the audit objective and, therefore, must be reported as an audit finding. In addition, the auditor must consider whether reportable conditions (and possibly, material weaknesses in internal control) exist and require reporting with respect to subrecipient monitoring.

Effect of Subrecipients' Noncompliance on the Pass-Through Entity's Report

9.38 The instances of noncompliance reported in subrecipients' audit reports are not required to be included in the pass-through entity's audit report. However, the auditor of the pass-through entity should consider the effects of reported instances of subrecipient noncompliance or indications of weaknesses in the pass-through entity's subrecipient-monitoring system that could have a material effect on each of the pass-through entity's major programs.

Adjustment of Pass-Through Entity Financial Records and Reports

9.39 Questioned costs at the subrecipient level that are found to be unallowable by the pass-through entity may require the pass-through entity to adjust its financial records and its federal expenditure reports. The total of allowable program costs in excess of required expenditure levels and the requirements of individual programs regarding the timing of claims will affect whether the pass-through entity will need to reflect a liability to the awarding agency in its financial statements. As part of the finding-resolution process, the pass-through entity should estimate the total unallowable costs that are associated with each subrecipient finding and consider the need to adjust financial records and federal expenditure reports. The failure of the pass-through entity to adjust its records and federal reports should be considered by the auditor in forming an opinion on compliance for major programs.

For-Profit Subrecipients

9.40 Since Circular A-133 does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. Circular A-133 states that the contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits. The auditor's responsibilities related to for-profit subrecipients are similar to those of not-for-profit subrecipients, see paragraphs 9.24 through 9.35 (as applicable) for a further discussion of subrecipient monitoring.

Non-U.S.-Based Entities

9.41 Circular A-133 does not apply to non-U.S.-based entities expending federal awards received either directly as a recipient or indirectly as a subrecipient (see paragraph 2.6 for a further discussion of non-U.S.-based entities). Therefore, the responsibilities that a pass-through entity and its auditor have for a non-U.S.-based entity are the same as those for a for-profit subrecipient (see paragraph 9.40).

State Designation of a Cluster of Programs

9.42 Circular A-133 includes a provision that allows a state to designate as a cluster a grouping of closely related programs that share common compliance requirements. When designating a cluster of programs, a state is required by Circular A-133 to identify the federal awards included in the cluster and to advise subrecipients of the compliance requirements applicable to the cluster. See paragraphs 1.18, 1.19, 2.18, 5.6, 7.4, and 8.30 for additional discussion of clusters.

Circular A-133 Audit Considerations of Subrecipients

9.43 Auditors of subrecipients should be aware that subrecipients have additional considerations under Circular A-133. These considerations are related to additional compliance requirements established by the pass-through entity, information included in the schedule of expenditures of federal awards, audit findings, and the submission of the report.

Additional Compliance Requirements Established by Pass-Through Entities

9.44 Federal awards are normally distributed to subrecipients only on the basis of properly completed and approved awards. These written agreements require subrecipients to comply with the requirements of the federal agency and, in some instances, additional requirements established by the pass-through entity. Hence, in addition to providing an audit satisfying the requirements of Circular A-133, the auditor may be engaged to test compliance with requirements specified by the pass-through entity.

Information Included in the Schedule of Expenditures of Federal Awards

9.45 For federal awards received as a subrecipient, the schedule of expenditures of federal awards is required to include the name of the pass-through entity and identifying number assigned by the pass-through entity. Circular A-133 states that to make the schedule easier to use, subrecipients may choose to provide information requested by federal awarding agencies and pass-through entities, although this information is not required. Chapter 5 includes more detailed information about the schedule.

Audit Findings

9.46 Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Circular A-133 states that where practical, audit findings should be organized by federal agency or pass-through entity (see chapter 10 for an additional discussion of audit findings).

Submission of Report

9.47 Section 320(e) of Circular A-133 has additional report-submission responsibilities for subrecipients. When a subrecipient is not required to submit a reporting package to the pass-through entity (because it has no audit findings or the summary schedule of prior audit findings does not report the status of any audit findings), the subrecipient is required to provide written notification of this to the pass-through entity. The required contents of the written notification and the submission of the report by subrecipients are discussed in paragraph 10.76.

Chapter 10

AUDITOR REPORTING REQUIREMENTS AND OTHER COMMUNICATION CONSIDERATIONS IN A SINGLE AUDIT

Overview

10.1 In this chapter the auditor's reporting requirements and other communication considerations in a single audit under Circular A-133 are discussed. The auditor's reporting requirements in a program-specific audit are discussed in chapter 11.

10.2 The auditor's reporting responsibilities in a single audit are driven by the three levels of auditing standards and requirements: GAAS, *Government Auditing Standards*, and Circular A-133. These standards and requirements expand the level of auditor responsibility from reporting on an auditee's financial statements to also reporting on internal control and on compliance. The auditor has additional reporting responsibilities for the audit of the financial statements in accordance with *Government Auditing Standards* (see chapter 4), and for the compliance audit applicable to major programs in accordance with Circular A-133 (see chapters 6 through 8). The auditor also has additional communication considerations under GAAS and *Government Auditing Standards* related to matters noted in the single audit.

Circular A-133 Requirements

Auditor's Reports

10.3 Circular A-133 requires the auditor's report(s) to include—

- An opinion (or disclaimer of opinion) on whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles (GAAP) (see paragraph 10.12 for a discussion of the basis of accounting) and an opinion (or a disclaimer of opinion) on whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- A report on the internal control related to the financial statements and on the internal control related to major programs. This report must describe the scope of testing of internal control and the results of the tests and, where applicable, must refer to the separate schedule of findings and questioned costs.
- A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report must also include an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program, and where applicable, must refer to the separate schedule of findings and questioned costs.

- A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67).

The auditor's reports recommended in this SOP are described in paragraphs 10.8 through 10.10 below.

Data Collection Form

10.4 Circular A-133 also requires the auditor to complete applicable sections and sign a data collection form that summarizes the auditor's results, findings, and questioned costs (see paragraphs 10.71 through 10.73).

Other Communication Considerations

10.5 The auditor has certain additional communication considerations under GAAS and *Government Auditing Standards* related to internal control, noncompliance, fraud, illegal acts, and other matters noted in the single audit (see paragraphs 10.13 through 10.30).

Reporting Package

10.6 The auditee is required to submit a reporting package that includes the following:

- Financial statements and a supplementary schedule of expenditures of federal awards (see chapters 4 and 5);
- Auditor's reports (see paragraphs 10.8 through 10.10);
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70);
- A corrective action plan (see paragraphs 10.68 through 10.70).

10.7 Although not part of the reporting package, the report submission to the Federal Audit Clearinghouse (FAC) must also include the data collection form described in paragraphs 10.71 through 10.73. The requirements for report submission are discussed in paragraphs 10.74 through 10.79.

Recommended Auditor's Reports

10.8 Reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued:

- a. An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards (see paragraph 10.35 through 10.37)¹
- b. A report on compliance and on internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards* (see paragraphs 10.38 through 10.40)

¹ Note that in certain circumstances the auditor may report on the schedule of expenditures of federal awards in his or her report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133. See paragraph 10.36 for a further discussion.

- c. A report on compliance with requirements applicable to each major program and on internal control over compliance in accordance with Circular A-133 (see paragraphs 10.46 through 10.54)
- d. A schedule of findings and questioned costs (see paragraphs 10.55 through 10.67)

10.9 Example reports are provided in appendix D of this SOP. As noted previously, those reports combine reports on compliance and internal control at the financial statement audit level and at the major program compliance audit level. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. The basic elements of each of the recommended reports are discussed later in this chapter. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

10.10 Table 10.1 provides a matrix depicting the recommended auditor's reports in a single audit required by GAAS, *Government Auditing Standards*, and Circular A-133.

Table 10.1

Recommended Reporting in Single Audits

<i>Report</i>	<i>Required by—</i>		
	<i>GAAS</i>	<i>Government Auditing Standards</i>	<i>Circular A-133</i>
Opinion (or disclaimer of opinion) on financial statements and supplementary schedule of expenditures of federal awards	X	X	X
Report on compliance and on internal control over financial reporting based on an audit of financial statements		X	X
Report on compliance and internal control over compliance applicable to each major program (this report must include an opinion [or a disclaimer of opinion] on compliance)			X
Schedule of findings and questioned costs			X

Reporting on the Financial Statements and Supplementary Schedule of Expenditures of Federal Awards in Accordance With GAAS and *Government Auditing Standards*

10.11 In this section the reporting and additional communication requirements under GAAS and *Government Auditing Standards* that are related to a financial statement audit and the supplementary schedule of expenditures of federal awards are discussed.

Basis of Accounting

10.12 Circular A-133 and *Government Auditing Standards* do not prescribe the basis of accounting that must be used by auditees to prepare their financial statements and the schedule of expenditures of federal awards. However, auditees are required to disclose the basis of accounting and the significant accounting policies used in preparing the financial statements and the schedule of expenditures of federal awards. The auditee must also be able to reconcile amounts presented in the financial statements to related amounts included in the schedule of expenditures of federal awards. The auditor is required to report whether the financial statements are presented fairly in all material respects in conformity with GAAP and whether the schedule of expenditures of federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole (see paragraphs 4.3 and 10.13 for a discussion of the auditor's responsibilities when the auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP).

GAAS Requirements

10.13 The applicable reporting requirements are established in SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508). For an auditee that prepares its financial statements in conformity with a basis of accounting other than GAAP, auditors should follow the guidance in SAS No. 62, *Special Reports*. In reporting on the supplementary schedule of expenditures of federal awards, auditors should follow the guidance in SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551). Auditors may also refer to the AICPA Audit and Accounting Guides *Not-For-Profit Organizations*, *Audits of State and Local Governmental Units*, *Health Care Organizations*, and *Audits of Colleges and Universities*² for additional guidance on reporting on the financial statements of specific industries. See also paragraphs 10.17 through 10.30 for a discussion of additional reporting and communication requirements.

10.14 SAS No. 61, *Communication With Audit Committees*,* requires the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for the oversight of the financial reporting process. Matters to be communicated include (among other things) the auditor's responsibilities, significant accounting policies, management judgments and accounting estimates, significant audit adjustments, disagreements with management, and difficulties encountered in performing the audit. In addition to the SAS No. 61 requirements described above, *Government Auditing Standards* also requires the auditor to communicate certain information during the planning stages of the audit. See paragraphs 3.14 and 3.15 for a further discussion.

² Auditors should note that although *Audits of Colleges and Universities* has been superseded by *Not-for-Profit Organizations*, it continues to be applicable in a governmental environment (that is, public institutions).

* In December 1999, the AICPA Auditing Standards Board issued SAS No. 89, *Audit Adjustments*, which, among other matters, amends SAS No. 61 to require the auditor to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. SAS No. 89 is effective for audits of financial statements for periods beginning on or after December 15, 1999. Early adoption is permitted.

Government Auditing Standards Requirements

10.15 Government Auditing Standards requires that in addition to reporting on the financial statements, the auditor report on (1) compliance with laws, regulations, and provisions of contracts and grant agreements that could have a direct and material effect on the financial statements amounts and (2) the scope of testing of the auditee's internal control over financial reporting and on the results of the tests.

10.16 The reporting standards for financial audits in *Government Auditing Standards* contain four additional reporting standards for financial statement audits beyond GAAS:

- a. When the report on the financial statement is submitted to comply with a requirement for an audit in accordance with *Government Auditing Standards*, audit reports should state that the audit was made in accordance with generally accepted government auditing standards. This SOP recommends the following language be included in the auditor's report to meet this requirement: "we conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States."³ *Government Auditing Standards* also acknowledges that an auditee may need a financial statement audit for purposes other than to comply with a requirement calling for an audit in accordance with *Government Auditing Standards*. For example, the auditee may need a financial statement audit to issue bonds. In this case, *Government Auditing Standards* permits auditors to issue a separate report on the financial statements conforming only to the requirements of GAAS (see paragraphs 5.11 through 5.14 of *Government Auditing Standards*).
- b. The report on the audit of the financial statements should either (1) describe the scope of the auditor's testing of compliance with laws and regulations and internal control over financial reporting and present the results of those tests or (2) refer to separate report(s) containing that information (see paragraphs 5.15 through 5.28 of *Government Auditing Standards*). When auditors report separately on compliance with laws and regulations and internal control over financial reporting, the report on the financial statements should state that they have issued the additional report. It should also state that the report on compliance with laws and regulations and internal control over financial reporting is an integral part of an audit performed in accordance with *Government Auditing Standards*, and in considering the results of the audit, that the report(s) should be read in conjunction with the auditor's report on the financial statements. The financial statement reporting recommended in this SOP (appendix D, examples 1 and 1a), illustrates the second option to refer to a separate report on compliance with certain provisions of laws, regulations, contracts, and grants and on internal control over financial reporting. In presenting the results of tests, the auditor should report fraud, illegal acts, other material noncompliance, and reportable conditions in internal control (see paragraphs 10.17 through 10.30).

³ The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

In some circumstances, the auditor should report fraud and illegal acts directly to parties external to the audited entity (see paragraphs 10.23 through 10.25).

- c. If certain information is prohibited from general disclosure (that is, prohibited from general disclosure by federal, state, or local laws or regulations), the audit report should state the nature of the information omitted and the requirement that makes the omission necessary (see paragraphs 5.29 through 5.31 of *Government Auditing Standards*).
- d. Written audit reports are to be submitted by the audit organization to the appropriate officials of the auditee and to the appropriate officials of the organizations requiring or arranging for the audit (including external funding organizations), unless legal restrictions prevent it.⁴ Copies of the reports should also be sent to other officials who have legal oversight authority or who may be responsible for acting on audit findings and recommendations and to others authorized to receive such reports. Unless restricted by law or regulation, copies should be made available for public inspection (see paragraphs 5.32 through 5.35 of *Government Auditing Standards*).

Fraud, Illegal Acts, and Other Noncompliance

GAAS Requirements

10.17 In SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317.17), the auditor's responsibilities with respect to the consideration of illegal acts,⁵ including communications with the audit committee or others with equivalent authority or responsibility are discussed.⁶ Paragraph 17 of SAS No. 54, requires the auditor to assure himself or herself that the audit committee or others with equivalent authority and responsibility are adequately informed with respect to illegal acts that come to the auditor's attention. The auditor need not communicate matters that are clearly inconsequential and may reach agreement in advance with the audit committee on the nature of such matters to be communicated. The communication should describe the act, the circumstances of its occurrence, and its effect on the financial statements. If senior management is involved, the auditor should communicate directly with the audit committee. The communication may be oral or written. If the communication is oral, the auditor should document it. Paragraphs 4.24 through 4.31 summarize the other requirements of SAS No. 54. The auditor should also consider the effect of any noncompliance on the financial statements, and should modify the auditor's report on those financial statements as necessary in accordance with SAS No. 58.

10.18 The auditor's responsibilities for communications about fraud to management, the audit committee, and others based on a financial statement audit in accordance with GAAS are discussed in SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*. Whenever the auditor has determined

⁴ Note that when public accountants are engaged, the engaging organization should ensure that the report is distributed appropriately.

⁵ SAS No. 54 defines the term *illegal acts* as violations of laws or government regulations.

⁶ For auditees that do not have audit committees, the phrase "others with equivalent authority and responsibility" may include the board of directors, the board of trustees, or the owner in owner-managed entities.

that there is evidence that fraud may exist, that matter should be brought to the attention of an appropriate level of management. This is generally appropriate even if the matter might be considered inconsequential, such as a minor defalcation by an employee at a low level in the auditee's organization. Fraud involving senior management and fraud that causes a material misstatement of the financial statements should be reported directly to the audit committee. The disclosure of possible fraud to parties other than the auditee's senior management and its audit committee is ordinarily not part of the auditor's responsibility and would ordinarily be precluded by the auditor's ethical or legal obligations of confidentiality unless the matter is reflected in the auditor's report. The auditor should recognize, however, that in the following circumstances a duty to disclose outside the auditee may exist:

- To comply with certain legal and regulatory requirements
- To a successor auditor when the successor makes inquiries in accordance with SAS No. 84, *Communications Between Predecessor and Successor Auditors*
- In response to a subpoena
- To a funding agency or other specified agency in accordance with the requirements for audits of entities that receive governmental financial assistance (see paragraphs 10.23 through 10.25)

10.19 When the auditor, as a result of the assessment of the risk of material misstatement due to fraud, has identified risk factors 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 risk factors represent reportable conditions that relate to the auditee's internal control and that should be communicated to senior management and the audit committee (see paragraphs 10.26 through 10.30). The auditor may also wish to communicate other risk factors that are identified, when the auditee can reasonably take actions to address the risk.

10.20 In paragraphs 38 through 40 of SAS No. 82 (AICPA, *Professional Standards*, vol. 1, AU sec. 316.38–40), the communication requirements of SAS No. 82 are further discussed. In paragraphs 4.32 through 4.37 of this SOP, the other requirements of SAS No. 82 are summarized. See paragraphs 6.7 through 6.12 for a discussion of the auditor's consideration of fraud risk in an audit of an auditee's compliance with specified requirements applicable to its major programs.

Government Auditing Standards Requirements

10.21 With regard to fraud and illegal acts, *Government Auditing Standards* requires auditors to report relevant information (in writing) when the auditor concludes, based on evidence obtained, that fraud or an illegal act has occurred or is likely to have occurred.^[7] Auditors do not need to report information about fraud or illegal acts that is clearly inconsequential. Therefore, auditors are required to present in the report the same fraud and illegal acts that they report to audit committees under GAAS (see paragraphs 10.17 through 10.20). *Government Auditing Standards* also requires auditors to report other noncompliance (for example, a violation of a contract provision) that is material

^[7] [Deleted.]

to the financial statements. In presenting fraud, illegal acts, or other noncompliance that are required to be reported, auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* for objectives, scope, and methodology; audit results; the views of responsible officials; and report presentation standards (as appropriate).

10.22 When auditors detect fraud, illegal acts, or other noncompliance that do not meet the criteria in paragraph 5.18 of *Government Auditing Standards* for reporting (summarized in paragraph 10.21), paragraph 5.20 of *Government Auditing Standards* requires auditors to communicate those findings to the auditee, preferably in writing. If auditors have communicated those findings in a management letter to top management, they should refer to that management letter when they are reporting on compliance. Auditors should document in their working papers all communications to the auditee about fraud, illegal acts, or other noncompliance.

Direct Reporting of Fraud and Illegal Acts

10.23 Paragraphs 5.21 through 5.25 of *Government Auditing Standards* provide guidance on the direct reporting of fraud and illegal acts. *Government Auditing Standards* requires that in addition to any legal requirements for the direct reporting of fraud or illegal acts, auditors must report fraud or illegal acts directly to parties outside the auditee in the following two circumstances (auditors should meet these requirement even if they have resigned or been dismissed from the audit):

- a. The auditee may be required by law or regulation to report certain fraud or illegal acts to specified external parties (for example, to a federal inspector general or a state attorney general). If auditors have communicated such fraud or illegal acts to the auditee, and it fails to report them, then auditors should communicate their awareness of that failure to the auditee's governing body. If the auditee does not make the required report as soon as practicable after the auditors' communication with its governing body, then the auditors should report the fraud or illegal acts directly to the external party specified in the law or regulation.
- b. When fraud or an illegal act involves assistance received directly or indirectly from a government agency, auditors may have a duty to report it directly if management fails to take remedial steps. If auditors conclude that such failure is likely to cause them to depart from the standard report on the financial statement or resign from the audit, then they should communicate that conclusion to the auditee's governing body. Then, if the auditee does not report the fraud or illegal act as soon as practicable to the entity that provided the government assistance, the auditors should report the fraud or illegal act directly to that entity.

10.24 In both of these situations, auditors should obtain sufficient, competent, and relevant evidence (for example, by confirmation with outside parties) to corroborate assertions by management that it has reported fraud or illegal acts. If they are unable to do so, the auditors should report the fraud or illegal acts directly, as discussed previously.

10.25 Paragraph 4.16 of *Government Auditing Standards* reminds auditors that under some circumstances, laws, regulations, or policies may require them to report indications of certain types of fraud or illegal acts promptly to

law enforcement or investigatory authorities. When auditors conclude that this type of fraud or illegal act either has occurred or is likely to have occurred, they should ask those authorities, legal counsel, or both, if reporting certain information about that fraud or illegal act would compromise investigative or legal proceedings. Auditors should limit their reporting to matters that would not compromise those proceedings, such as information that is already a part of the public record.

Internal Control Over Financial Reporting

10.26 SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, provides guidance in identifying and reporting conditions that relate to an auditee's internal control observed during an audit of financial statements. In addition to providing guidance on communicating reportable conditions and identifying material weaknesses in the internal control over financial reporting, SAS No. 60 states that because timely communication may be important, the auditor may choose to communicate significant matters related to the internal control over financial reporting during the course of the audit rather than after the audit is concluded.

10.27 Written reporting on internal control matters under *Government Auditing Standards* is based on the auditor's consideration of the internal control over financial reporting as required by SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to SAS No. 55*. The report does not express an opinion on the auditee's internal control over financial reporting, but rather describes the extent of the work performed, as required by SAS No. 55. The report includes the requirements of SAS No. 60, as well as the additional requirements of *Government Auditing Standards*.

10.28 With regard to matters noted in an audit that relate to the internal control over financial reporting, paragraph 5.26 of *Government Auditing Standards* requires auditors to report deficiencies in internal control that they consider to be reportable conditions as defined by SAS No. 60. Paragraph 17 of SAS No. 60 prohibits the auditor from issuing a written report representing that no reportable conditions were noted during an audit. The illustrative report in example 2 of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when no reportable conditions are noted during an audit. In reporting reportable conditions, auditors are required to identify those that are individually or cumulatively material weaknesses. Auditors should follow the report contents standards in chapter 7 of *Government Auditing Standards* when reporting reportable conditions or material weaknesses. The illustrative report in example 2a of appendix D provides recommended language that satisfies the requirements of *Government Auditing Standards* when reportable conditions (whether or not they are considered to be material weaknesses) are noted during an audit.

10.29 Paragraph 5.28 of *Government Auditing Standards* states that when auditors detect deficiencies in the internal control that are not reportable conditions, they should communicate those deficiencies to the auditee, preferably in writing. If the auditors have communicated those deficiencies in internal control in a management letter to top management, they should refer to that management letter when they report on internal control (examples 2 and

2a of appendix D illustrate such a reference to the management letter). All communications to the auditee about deficiencies in the internal control should be documented in the working papers.

10.30 The following table summarizes the differences between SAS No. 60 and *Government Auditing Standards* with respect to reporting internal control matters.

	Government Auditing Standards	SAS No. 60
When is reporting required?	In every financial statement audit	When reportable conditions are noted
What is the form of the report?	Written	Oral or written, preferably in writing
Should the auditor separately identify those reportable conditions that are significant enough to be material weaknesses?	Yes	Permitted but not required

Reporting When Portions of a Governmental Reporting Entity Do Not Have an Audit in Accordance With *Government Auditing Standards*

10.31 Since the implementation of Governmental Accounting Standards Board (GASB) Statement No. 14, *The Financial Reporting Entity*, it is becoming more frequent for governments that are required to have an audit in accordance with *Government Auditing Standards* to include as part of the reporting entity component units that are not required to have such an audit. When this occurs, the auditor should consider modifying his or her report on the financial statements and also the report issued to meet the requirements of *Government Auditing Standards*.

10.32 With regard to the report on the financial statements of the reporting entity, if a material component unit or fund is not required to have an audit in accordance with *Government Auditing Standards* and the report on the financial statements is required to state that the audit was performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of the report on the financial statements to indicate the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*. An audit includes examining

10.33 With regard to the report issued on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*, the auditor should modify the scope paragraph of example 2 or 2a of appendix D to indicate

the portion of the reporting entity that was not audited in accordance with *Government Auditing Standards*. Example wording that could be used in this situation follows:

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. The financial statements of [name of fund or component unit] were not audited in accordance with *Government Auditing Standards*.

Implementing Regulations of Certain Federal Awarding Agencies May Define Entity to Be Audited Differently Than GAAP

10.34 The regulations implementing Circular A-133 may define the entity to be audited for single audit purposes differently than the reporting entity would be defined in accordance with GAAP. For example, SOP 94-3, *Reporting of Related Entities by Not-for-Profit Organizations*, requires presentation of consolidated financial statements when one NPO (the parent) controls the voting majority of the Board of and has an economic interest in another NPO. If the regulations of the federal agency that provides federal awards to the parent define the entity for single audit purposes to consist of only the parent, audited parent-only financial statements instead of consolidated financial statements must be submitted to comply with these regulations. If consolidated financial statements are not also prepared as required by GAAP, the auditor should consider whether other than an unqualified opinion due to a material departure from GAAP should be expressed on the parent-only financial statements. See paragraphs 35 through 60 of SAS No. 58, *Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508.35–.60) for guidance on reporting when there is a departure from GAAP.

Opinion on the Financial Statements and on the Supplementary Schedule of Expenditures of Federal Awards

Report Requirements

10.35 The auditor's standard report on the financial statements and on the supplementary schedule of expenditures of federal awards identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion on the financial statements and supplementary schedule of expenditures of federal awards in separate opinion paragraphs. The basic elements of the report are—

- a. A title that includes the word *independent*.
- b. A statement that the financial statements identified in the report were audited.
- c. A statement that the financial statements are the responsibility of the auditee's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.

- d. A statement that the audit was conducted in accordance with GAAS and the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.⁸
- e. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- f. A statement that an audit 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.
 - Evaluating the overall financial statement presentation.
- g. A statement that the auditor believes that the audit provides a reasonable basis for his or her opinion.
- h. For a government, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the balance sheet date, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the period then ended in conformity with GAAP; for a not-for-profit organization, an opinion on whether the financial statements present fairly, in all material respects, the financial position of the auditee as of the date of the statement of financial position, and the changes in its net assets and its cash flows for the period then ended in conformity with GAAP.⁹
- i. A reference to the separate report on compliance with certain provisions of laws, regulations, contracts, and grant agreements and on the internal control over financial reporting prepared in accordance with *Government Auditing Standards*¹⁰ which includes a statement that the separate report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with the report on the financial statements in considering the results of the audit. If the reporting on compliance and internal control over financial reporting is included in the report on the financial statements, the reference to the separate report is not required (this SOP recommends separate reporting). See paragraph 10.16.
- j. A description of the accompanying supplementary information (for example, the schedule of expenditures of federal awards, combining and individual fund and account group financial statements and schedules, etc.). This identification may be by descriptive title or by page number of the document.
- k. A statement that the accompanying supplementary information, including the schedule of expenditures of federal awards required by

⁸ See footnote 3.

⁹ If an auditee prepares its financial statements in conformity with a comprehensive basis of accounting other than GAAP, the auditor is still required to express or disclaim an opinion and should follow the reporting in SAS No. 62, *Special Reports*.

¹⁰ See paragraphs 10.15, 10.16, and 10.21 through 10.30 for a discussion of reporting on compliance and on the internal control based on a financial statement audit in accordance with *Government Auditing Standards*.

Circular A-133, is presented for purposes of additional analysis and is not a required part of the financial statements.¹¹ See paragraph 10.36.

- l. An opinion on whether the accompanying supplementary information is fairly stated, in all material respects, in relation to the financial statements taken as a whole.
- m. The manual or printed signature of the auditor's firm.
- n. The date of the audit report.

Reporting on the Schedule of Expenditures of Federal Awards

10.36 This SOP recommends that the auditor report on the schedule of expenditures of federal awards in the report on the financial statements. However, some entities do not present the schedule with the financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate how to incorporate the reporting on the schedule into the Circular A-133 report. See also paragraphs 10.50 through 10.52 for information on dating the reports in this situation and paragraph 10.13 for a further discussion of reporting on the schedule.

10.37 Examples of the auditor's opinion on the financial statements and on the supplementary schedule of expenditures of federal awards are presented in examples 1 and 1a of appendix D.

Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With Government Auditing Standards

10.38 This SOP recommends that the reporting on the scope of the auditor's testing of compliance and on the internal control over financial reporting based on an audit of the financial statements as required by *Government Auditing Standards* be combined in one report (see paragraphs 10.8 through 10.10).

10.39 The basic elements of the auditor's standard report on compliance and on the internal control over financial reporting (see paragraph 4.12) based on an audit of the financial statements in accordance with *Government Auditing Standards* are—

- a. A statement that the auditor has audited the financial statements of the auditee and a reference to the auditor's report on the financial statements, including a description of any departure from the standard report.
- b. A statement that the audit was conducted in accordance with GAAS and with the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States.¹²
- c. A statement that as part of obtaining reasonable assurance about whether the auditee's financial statements are free of material misstatement, the auditor performed tests of the auditee's compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts.

¹¹ If the report on the financial statements is issued for an audit that is not subject to Circular A-133 (that is, an audit in accordance with GAAS and *Government Auditing Standards* only), this reference to the schedule of expenditures of federal awards and Circular A-133 should be deleted.

¹² See footnote 3.

- d. A statement that providing an opinion on compliance with those provisions was not an objective of the audit and that, accordingly, the auditor does not express such an opinion.
- e. A statement that notes whether the results of tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*¹³ and, if they are, describes the instances of noncompliance or refers to the schedule of findings and questioned costs in which they are described.¹⁴
- f. If applicable, a statement that certain immaterial instances of non-compliance were communicated to management in a separate letter.¹⁵
- g. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over financial reporting in order to determine the auditing procedures for the purpose of expressing an opinion on the financial statements and not to provide assurance on the internal control over financial reporting.
- h. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- i. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- j. If applicable, a description of the reportable conditions noted or a reference to the schedule of findings and questioned costs in which the reportable conditions are described.¹⁶
- k. The definition of a material weakness.
- l. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, describes the material weaknesses noted or refers to the schedule of findings and questioned costs in which they are described.¹⁷ If there are no reportable conditions noted, a statement is made that no material weaknesses were noted.

¹³ See paragraph 10.21 for a discussion of noncompliance matters that need to be reported under *Government Auditing Standards*.

¹⁴ For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), any reportable instances of noncompliance, reportable conditions, and material weaknesses can either be described in the body of the report or the report can refer to a separate schedule that summarizes the findings noted. This statement should be modified accordingly. For an audit in accordance with Circular A-133, all findings, including those required to be reported under *Government Auditing Standards*, must be included in the schedule of findings and questioned costs.

¹⁵ See paragraph 10.22 for a discussion of reporting other noncompliance matters to top management in accordance with *Government Auditing Standards*.

¹⁶ See footnote 14.

¹⁷ See footnote 14.

- m. If applicable, a statement that other matters involving the internal control over financial reporting were communicated to management in a separate letter.¹⁸
- n. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, specified 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.^{19, 20}
- o. The manual or printed signature of the auditor's firm.
- p. The date of the auditor's report.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

10.40 Examples of the auditor's report on compliance and on the internal control over financial reporting based on an audit of the financial statements in accordance with *Government Auditing Standards* are included in examples 2 and 2a of appendix D.

Reporting on a Compliance Audit of Major Federal Programs

10.41 In this section the auditor's reports that are issued based on a compliance audit of major programs in accordance with Circular A-133 are discussed. The report on compliance with requirements applicable to major programs expresses the auditor's opinion on whether the auditee complied with the requirements that, if noncompliance occurred, could have a direct and material effect on a major program. Although the guidance in SAS No. 58 addresses reporting on audited financial statements, auditors may find its guidance useful when reporting on a compliance audit of major programs.

Material Instances of Noncompliance

10.42 When the audit of an auditee's compliance with requirements applicable to a major program detects material instances of noncompliance with those requirements, the auditor should express a qualified or adverse opinion. The auditor should state the basis for such an opinion in the report (see examples 3a and 5 of appendix D). The auditor should also consider the cumulative effect of all instances of noncompliance on the financial statements. See paragraphs 6.13 through 6.16 for a further discussion of material instances of noncompliance.

Scope Limitations

10.43 Testing an auditee's compliance with laws, regulations, and the provisions of contracts or grant agreements (referred to as "compliance require-

¹⁸ See paragraph 10.29 for a discussion of other internal control matters to be communicated to top management in accordance with *Government Auditing Standards*.

¹⁹ For an audit that is not subject to Circular A-133 (that is, in accordance with *Government Auditing Standards* only), the reference to federal awarding agencies and pass-through entities should be deleted.

²⁰ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports. [Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

ments”) requires the auditor to make a comply/noncomply decision about an auditee’s adherence to those compliance requirements. The auditor is able to express an unqualified opinion only if he or she has been able to apply all the procedures the auditor considers necessary in the circumstances. Restrictions on the scope of the audit—whether imposed by the client or by circumstances such as the timing of the auditor’s work, an inability to obtain sufficient competent evidential matter, or an inadequacy in the accounting records—may require auditors to qualify their opinion or to disclaim an opinion. In these instances, the reasons for such a qualification or disclaimer of opinion should be described in the auditor’s report. Furthermore, the auditor should consider the effects of such instances on his or her ability to express an unqualified opinion on the financial statements. See example 4 of appendix D for an illustration of a qualified opinion on compliance due to a scope limitation.

10.44 The auditor’s decision to qualify or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on compliance with requirements governing each major program. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to each major program. When restrictions that significantly limit the scope of the audit are imposed by the client, the auditor generally should disclaim an opinion on compliance.

10.45 When disclaiming an opinion because of a scope limitation, the auditor should indicate in a separate paragraph all of the substantive reasons for the disclaimer. The auditor should state that the scope of his or her audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed or include a paragraph describing the characteristics of an audit (that is, the scope paragraph); to do so may tend to overshadow the disclaimer. In addition, the auditor should disclose any reservations he or she has regarding compliance with applicable laws and regulations.

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With Circular A-133

Report Requirements

10.46 The basic elements of the auditor’s standard report on compliance with requirements applicable to each major program and on the internal control over compliance (see paragraph 4.12) in accordance with Circular A-133 are—

- a. A statement that the auditor has audited the compliance of the auditee with the types of compliance requirements described in the *OMB Circular A-133 Compliance Supplement* that are applicable to each of its major programs.
- b. A statement that the auditee’s major programs are identified in the summary of the auditor’s results section of the accompanying schedule of findings and questioned costs (see paragraph 10.56).
- c. A statement that compliance with the requirements of laws, regulations, contracts, and grants applicable to each of the auditee’s major

federal programs is the responsibility of the auditee's management, and that the auditor's responsibility is to express an opinion on the auditee's compliance based on the audit.

- d. A statement that the audit of compliance was conducted in accordance with GAAS, the standards applicable to financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States,²¹ and Circular A-133.
- e. A statement that those standards and Circular A-133 require that the auditor plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements that could have a direct and material effect on a major federal program occurred.
- f. A statement that an audit includes the examining, on a test basis, evidence about the auditee's compliance with those requirements and performing of such other procedures as the auditor considered necessary in the circumstances.
- g. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion.
- h. A statement that the audit does not provide a legal determination of the auditee's compliance with those requirements.
- i. If instances of noncompliance are noted that result in an opinion modification, a reference to a description in the accompanying schedule of findings and questioned costs, including—
 - The reference number(s) of the finding(s).
 - An identification of the type(s) of compliance requirements and related major program(s).
 - A statement that compliance with such requirements is necessary, in the auditor's opinion, for the auditee to comply with the requirements applicable to the program(s).
- j. An opinion on whether the auditee complied, in all material respects, with the types of compliance requirements that are applicable to each of its major federal programs.
- k. If applicable, a statement that the results of the auditing procedures disclosed instances of noncompliance that are required to be reported in accordance with Circular A-133 and a reference to the schedule of findings and questioned costs in which they are described.²²
- l. A statement that the auditee's management is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs.
- m. A statement that in planning and performing the audit, the auditor considered the auditee's internal control over compliance with require-

²¹ See footnote 3.

²² See paragraph 10.63 for a discussion of the audit findings that are required to be reported under Circular A-133.

ments that could have a direct and material effect on a major federal program, to determine the auditing procedures for the purpose of expressing an opinion on compliance and to test and report on the internal control over compliance in accordance with Circular A-133.

- n. If applicable, a statement that reportable conditions were noted and the definition of a reportable condition.
- o. If applicable, a reference to a description of reportable conditions noted in the accompanying schedule of findings and questioned costs, including the reference number of the finding(s).
- p. If no reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in internal control that might be material weaknesses; if reportable conditions are noted, a statement that the auditor's consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses.
- q. The definition of a material weakness.
- r. If applicable, a statement about whether the auditor believes any of the reportable conditions noted are material weaknesses and, if they are, a reference to a description of the material weaknesses in the schedule of findings and questioned costs, including the reference number of the finding(s). If there are no reportable conditions, a statement is made that no material weaknesses were noted.
- s. A separate paragraph at the end of the report stating that the report is intended solely for the information and use of the audit committee, management, specified 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.²³
- t. The manual or printed signature of the auditor's firm.
- u. The date of the auditor's report.

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Option to Report on the Schedule of Expenditures of Federal Awards

10.47 This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, in certain circumstances (for example, when a separate single-audit package is issued), the required reporting on the schedule may be incorporated into the report described in paragraph 10.46. See paragraph 10.36 for a further discussion. Examples 3 (footnote 34) and 3a (footnote 40) of appendix D, illustrate this reporting option.

No Requirement to Refer to Management Letter

10.48 It is important to note that all audit findings required to be reported under Circular A-133 must be included in the schedule of findings and ques-

²³ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports. [Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

tioned costs (see paragraphs 10.55 and 10.56). A separate letter (that is, management letter) may not be used to communicate such matters to top management in lieu of reporting them as audit findings in accordance with Circular A-133. Since all reportable findings are included in the schedule, there is no requirement for the auditor to refer to the management letter in the report described in paragraph 10.46.

10.49 An example of the auditor's report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133 is presented in examples 3, 3a, 4, and 5 of appendix D.

Other Reporting Considerations

Dating of Reports

10.50 Since the report on the supplementary schedule of expenditures of federal awards indicates that the auditor is reporting "in relation to" the basic financial statements, it should carry the same date as that on the report on these statements. Furthermore, since the report on compliance and internal control over financial reporting, as required by *Government Auditing Standards*, relates to the audit of the financial statements and is based on the GAAS audit procedures performed, it should also carry the same date.

10.51 The auditor's report on compliance and on the internal control over compliance related to major programs, as required by Circular A-133, should ordinarily have the same date as that of the other reports, but may carry a later date, because some of the audit work to satisfy Circular A-133 requirements may be done subsequent to the work on the financial statements. When this is the case, the reporting required by Circular A-133 should be dated at the later date (that is, when the fieldwork required to support the report on the audit of compliance is completed). The auditor should perform subsequent events procedures from the date of the report on the financial statements to the date of the report on the compliance audit in accordance with SAS No. 1, section 560, *Subsequent Events* (AICPA, *Professional Standards*, vol. 1, AU sec. 560). If, after issuing the report on the financial statements, the auditor becomes aware of instances of noncompliance that could be material to such statements, he or she should follow the guidance in SAS No. 1, section 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 561).

10.52 This SOP recommends reporting on the schedule of expenditures of federal awards in the report on the financial statements. However, as noted in paragraphs 10.36 and 10.47, there may be circumstances in which the auditor reports on the schedule in the report on compliance and the internal control over compliance issued to meet Circular A-133 requirements. In this situation, the report issued to meet Circular A-133 requirements must be dated the same as the report on the financial statements. This is because the report on the schedule is "in relation to" the basic financial statements. If using the same date is not possible because the work to satisfy Circular A-133 requirements is not complete as of the date of the financial statement report, the auditor has two options:

- a. The auditor can dual date the report issued to meet Circular A-133 requirements. The date relating to the portion of the report pertain-

ing to the schedule of expenditures of federal awards would be the same as the date of the financial statement report. The date pertaining to the remainder of the report would be the date on which the work done to satisfy Circular A-133 requirements is completed. Refer to SAS No. 1, section 530 *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 530).

- b. The auditor can issue a separate report on the schedule of expenditures of federal awards, dated the same date as that of the financial statement report.

In some instances, the auditor may be engaged to issue a stand-alone opinion on the schedule either as part of the report issued to meet the requirements of Circular A-133 or separately (dated the same as the Circular A-133 report). The auditor should follow the guidance in SAS No. 58 when issuing such a report.

Other Auditors

10.53 When more than one independent auditor is involved in a single audit performed under Circular A-133, the auditor should refer to guidance in paragraphs 12 and 13 of SAS No. 58 (AICPA, *Professional Standards*, vol. 1, AU sec. 508.12 and .13) regarding an opinion on financial statements based in part on the report of another auditor, as well as SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors* (AICPA, *Professional Standards*, vol. 1, AU sec. 543).

When the Audit of Federal Awards Does Not Encompass the Entirety of the Auditee's Operations

10.54 If the audit of federal awards did not encompass the entirety of the auditee's operations expending federal awards, the operations that are not included should be identified in a separate paragraph following the first paragraph of the report on major programs (see also the discussion in paragraph 3.30). An example of such a paragraph follows:

Example Entity's general-purpose financial statements include the operations of the [identify component unit or department], which received [include dollar amount] in federal awards which is not included in schedule during the year ended June 30, 19X1. Our audit, described below, did not include the operations of [identify component unit or department] because [state the reason for the omission, such as the component unit engaged other auditors to perform an audit in accordance with OMB Circular A-133].

Schedule of Findings and Questioned Costs

10.55 Circular A-133 requires the auditor to prepare a schedule of findings and questioned costs, which should include the following three sections:

- a. A summary of the auditor's results
- b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards*
- c. Findings and questioned costs for federal awards

What Should Be Reported

10.56 Specifically, Circular A-133 requires the schedule of findings and questioned costs to contain—

- a. A summary of the auditor's results, which must include—

- The type of report the auditor issued on the financial statements of the auditee (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.²⁴
 - A statement on whether the audit disclosed any noncompliance that is material to the financial statements of the auditee.
 - Where applicable, a statement that reportable conditions in the internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.²⁵
 - The type of report the auditor issued on compliance for major programs (that is, unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - A statement on whether the audit disclosed any audit findings that the auditor is required to report under section 510(a) of Circular A-133 (see paragraph 10.63).
 - An identification of major programs.
 - The dollar threshold used to distinguish between type A and type B programs as described in section 520(b) of Circular A-133 (see paragraphs 7.4 through 7.9).
 - A statement on whether the auditee qualified as a low-risk auditee under section 530 of Circular A-133 (see paragraph 7.25).
- b. Findings relating to the financial statements which are required to be reported in accordance with *Government Auditing Standards* (see the discussion in paragraphs 10.57 through 10.62 for further detail).
- c. Findings and questioned costs for federal awards, which must include audit findings as defined in section 510(a) of Circular A-133 (see paragraph 10.63). Circular A-133 also requires the following with regard to this section of the schedule:
- Audit findings (for example, internal control findings, compliance findings, questioned costs, or fraud) that relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by federal agency or pass-through entity.
 - Audit findings that relate to both the financial statements and the federal awards should be reported in both sections of the

²⁴ Auditors should note that SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, precludes an auditor from issuing a written report representing that no reportable conditions were noted during an audit. Therefore, the sample schedule of findings and questioned costs included in appendix E uses the term "none reported" to indicate that no reportable conditions were included in the auditor's report (versus "none," which would imply that there were no reportable conditions).

²⁵ See footnote 24.

schedule. However, the reporting in one section of the schedule may be in summary form, with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that affects the auditee as a whole, including its federal awards, should usually be reported in detail in the section of the schedule of findings and questioned costs that is related to the financial statements, with a summary identification and reference given in the section related to federal awards. Conversely, a finding of noncompliance with a federal program law that is also material to the financial statements should be reported in detail in the federal awards section of the schedule, with a summary identification and reference given in the financial statement section.

Findings Relating to the Financial Statements

10.57 As noted before, Circular A-133 requires the schedule of findings and questioned costs to include a section that reports the findings relating to the financial statements (note that these findings must also be addressed in the auditor's report issued to meet the requirements of *Government Auditing Standards*—see paragraphs 10.15, 10.16, and 10.21 through 10.30). This section of the schedule should include all reportable conditions in the internal control over financial reporting and other findings relative to the audit of the financial statements that are required to be reported by GAAS and *Government Auditing Standards*, including those that do not affect federal awards. In addition to requiring auditors to report reportable conditions in the internal control over financial reporting, *Government Auditing Standards* requires auditors to report all but clearly inconsequential fraud and illegal acts that the auditor concludes, based on the evidence obtained, either occurred or are likely to have occurred. *Government Auditing Standards* also requires the auditor to report other noncompliance (for example, violations of the provisions of contract or grant agreements) that is material to the financial statements (see paragraphs 10.21 and 10.22).

10.58 In reporting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should place their findings in proper perspective. This perspective is both quantitative and qualitative. To give the reader a basis to judge the prevalence and consequences of these conditions, the instances that are identified should be related to the universe or the number of cases examined and be quantified in terms of dollar value, if appropriate. Reportable conditions that are—either individually or in the aggregate—material weaknesses should be so identified.

10.59 *Government Auditing Standards* suggests that well-developed findings generally include the following elements:

- Criteria (what should be)
- The condition (what is)
- The effect (the difference between what is and what should be)
- The cause (why it happened)

10.60 *Government Auditing Standards* recognizes reportable conditions and noncompliance identified by the auditor may not always have all of the elements fully developed. However, to provide sufficient information to users

to permit them to determine the effect and cause in order to take prompt and proper corrective action, auditors should identify at least the criteria, condition, and possible asserted effect.

10.61 In presenting reportable conditions, fraud, illegal acts, and other noncompliance, auditors should follow the report content standards in chapter 7 of *Government Auditing Standards* that pertain to objectives, scope, and methodology; audit results; the views of responsible officials; and the reports presentation standards (as appropriate). Auditors may provide less extensive disclosure of fraud and illegal acts that are not material in either a quantitative or qualitative sense.

10.62 *Government Auditing Standards* also requires the auditor to report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit (see paragraph 6.65 for a discussion of the auditor's responsibility for audit follow-up under *Government Auditing Standards*). The auditor should report the status of uncorrected material findings and recommendations from prior audits that affect the financial statement audit. Material findings and recommendations from previous audits that are repeated as current-year findings should be identified as repeat findings. If there are uncorrected findings from previous audits that are not repeated as current-year findings, their status should also be reported by the auditor. In either case, this information should be provided for in the section of the schedule of findings and questioned costs related to the financial statements.

Audit Findings Reported—Federal Awards

10.63 Section 510(a) of Circular A-133 requires the auditor to report as audit findings in the schedule of findings and questioned costs—

- a. Reportable conditions in the internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition for the purpose of reporting an audit finding is in relation to a type of compliance requirement for a major program or to an audit objective identified in the *Compliance Supplement*. The auditor should identify reportable conditions that are individually or cumulatively material weaknesses (see paragraphs 8.25 and 8.26).
- b. Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements that are related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material 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 *Compliance Supplement* (see paragraphs 6.51 through 6.60 for a further discussion of the evaluation and reporting of noncompliance).
- c. Known questioned costs that are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor should consider the best estimate of the total costs questioned (likely questioned costs), not just the questioned costs specifi-

cally identified (known questioned costs). The auditor should also report (in the schedule of findings and questioned costs) known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. For example, if the auditor specifically identifies \$7,000 in questioned costs but, based on his or her evaluation of the effect of questioned costs on the opinion on compliance, estimates that the total questioned costs are in the \$50,000–\$60,000 range, the auditor should report a finding that identifies the known questioned costs of \$7,000. Although the auditor is not required to report his or her estimate of the total questioned costs, the auditor should include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- d. Known questioned costs that are greater than \$10,000 for programs that are not audited as major. Since (except for audit follow-up) the auditor is not required to perform audit procedures for federal programs that are not major, the auditor will normally not find questioned costs. However, if the auditor does become aware of questioned costs for a federal program that is not audited as a major program (for example, as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor should report this as an audit finding.
- e. The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for federal awards (for example, a scope limitation that is not otherwise reported as a finding).
- f. Known fraud affecting a federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of *Government Auditing Standards* (see paragraphs 10.23 through 10.25).
- g. Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with section 315(b) of Circular A-133 materially misrepresents the status of any prior audit finding (see paragraphs 10.68 through 10.70).

Detail of Audit Findings—Federal Awards

10.64 Section 510(b) of Circular A-133 requires that audit findings should be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for federal agencies and pass-through entities to arrive at a management decision. The specific information that Circular A-133 requires in audit findings consists of (as applicable)—

- a. Identification of the federal program and specific federal award including the CFDA title and number, the federal award number and year, the name of federal agency, and the name of the applicable

pass-through entity. When information such as the CFDA title and number or the federal award number is not available, the auditor should provide the best information available to describe the federal award.

- b.* The criteria or specific requirement upon which the audit finding is based, including the statutory, regulatory, or other citation.
- c.* The condition found, including facts that support the deficiency identified in the audit finding.
- d.* Identification of questioned costs and how they were computed.
- e.* Information to provide a proper perspective for judging the prevalence and consequences of the audit findings, (for example, whether the audit findings represent an isolated instance or a systemic problem). Where appropriate, the instances identified should be related to the universe and the number of cases examined and be quantified in terms of the dollar value.
- f.* The possible asserted effect to provide sufficient information to the auditee and federal agency (or pass-through entity, in the case of a subrecipient) to permit them to determine the cause and effect, to facilitate prompt and proper corrective action.
- g.* Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
- h.* To the extent practical, the views of responsible officials of the auditee when there is disagreement with the audit findings. If the auditee's corrective action plan is available and contains the views of the responsible officials, the auditor can indicate in the finding that the auditee disagreed with the finding and refer to the details of the auditee's position in the corrective action plan. However, if the auditor does not agree with the auditee's position, the auditor should state his or her reasons for rejecting it.

Other Preparation Guidance

10.65 Each audit finding in the schedule of findings and questioned costs should include a reference number to allow for easy referencing of the audit findings during follow-up. One option for assigning reference numbers is to use the last two digits of the fiscal year being audited as the first two digits of each reference number, followed by a numeric sequence. For example, findings identified and reported in the audit of fiscal year 199X would be assigned reference numbers 9X-1, 9X-2, etc.

10.66 A schedule of findings and questioned costs must be issued for every single audit, regardless of whether any findings or questioned costs are noted. This is because Circular A-133 requires that one section of the schedule summarize the audit results (see paragraphs 10.55 and 10.56). In a situation in which there are no findings or questioned costs, the auditor should prepare the summary of auditor's results section of the schedule and indicate in the other required sections that no matters were reportable.

10.67 Appendix E contains an illustrative schedule of findings and questioned costs.

Summary Schedule of Prior Audit Findings and Corrective Action Plan

10.68 The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee is required to prepare a summary schedule of prior audit findings. The auditee is not required to prepare a summary schedule of prior audit findings if there are no matters reportable therein. However, to best serve the needs of federal agencies and to avoid any potential future misunderstanding or allegation of nonconformity with the requirements of Circular A-133, the auditee may consider preparing in this circumstance a summary schedule circumstance that indicates that no matters are reportable. The auditee is also required to prepare a corrective action plan for each of the current-year audit findings. The summary schedule of prior audit findings and the corrective action plan, which are both part of the reporting package, must include the reference numbers the auditor assigns to audit findings in the schedule of findings and questioned costs. This numbering (or other identification) should include the fiscal year in which the finding initially occurred.

10.69 The auditor is required to follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current-year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of section 500(e) of Circular A-133 (see paragraphs 6.61 through 6.65).

10.70 The auditor has no responsibility for the corrective action plan; however, the auditor may be separately engaged by the auditee for assistance in developing appropriate corrective actions in response to audit findings. The auditor may find the auditee's corrective action plan useful in performing follow-up on prior audit findings (in addition to the schedule of prior audit findings), because it may provide an indication of the corrective steps planned by the auditee.

Data Collection Form

10.71 Circular A-133 requires the auditee to complete and sign certain sections of a data collection form that states whether the audit was completed in accordance with Circular A-133 and provides information about the auditee, its federal programs, and the results of the audit. This form is not part of the reporting package (see paragraph 10.7). The information required to be included in the form, however, represents a summary of the information contained in the reporting package, including the auditor's reports and the auditee's schedule of expenditures of federal awards.

10.72 The auditor is also required to complete certain sections of the form, including information on the auditor and information on the results of the financial statement audit and the audit of federal programs. The auditor is also required to sign a statement in the form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package, and that the content of the form is limited to the data elements prescribed by the OMB. As part of completing the form, the auditor is asked to date it. The date

that is entered by the auditor should be the date on which he or she completes and signs the form. The wording of the auditor's statement section of the form indicates that no additional procedures were performed since the date of the audit reports. This wording alleviates the auditor from any subsequent-event responsibility with regard to the timing of the completion of the form and the completion of the audit. The form includes detailed instructions, which should be carefully followed by the auditor.

10.73 The data collection form and related instructions are available on the OMB's home page at www.whitehouse.gov/WH/EOP/OMB/Grants (note that this address is "case sensitive," that is, upper- and lowercase letters must be as shown). A copy of the form and instructions can also be obtained from the Federal Audit Clearinghouse at (888) 222-9907. The form number is SF-SAC.²⁶

Submission of Reporting Package and Data Collection Form

10.74 The submission of the data collection form and the reporting package, including the audit reports, is the responsibility of the auditee. The data collection form and the reporting package must be submitted by the auditee within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. However, it should be noted that Circular A-133 includes a delayed implementation date for report-submission deadlines. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the data collection form and reporting package must be submitted within thirty days after the receipt of the auditor's reports, or thirteen months after the end of the audit period.

Submission to Clearinghouse

10.75 All auditees must submit to the federal clearinghouse designated by the OMB the data collection form and one copy of the reporting package (see paragraph 10.6 for a description) for (a) the federal clearinghouse to retain as an archival copy and (b) each federal awarding agency, when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the federal awarding agency provided directly or when the summary schedule of prior audit findings reported the status of any audit findings relating to federal awards that the federal awarding agency provided directly.

Submission by Subrecipients

10.76 In addition to the requirements in paragraph 10.75, auditees that are also subrecipients must submit to each pass-through entity one copy of the reporting package for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to federal awards that the pass-through entity provided or when the summary schedule of prior audit

²⁶ As of the issuance of this SOP, the Federal Audit Clearinghouse is developing the data collection form in various word processing packages, as well as a process for electronic submission. Auditors can review the Federal Audit Clearinghouse home page at <http://harvester.census.gov/sac> for the most current information on these developments.

findings reported the status of any audit findings relating to federal awards that the pass-through entity provided. When a subrecipient is not required to submit a reporting package to a pass-through entity, the subrecipient must instead provide written notification to the pass-through entity that—

- An audit of the subrecipient was conducted in accordance with Circular A-133 (including the period covered by the audit and the name, amount, and CFDA number of the federal awards provided by the pass-through entity).
- The schedule of findings and questioned costs disclosed no audit findings relating to the federal awards that the pass-through entity provided.
- The summary schedule of prior audit findings did not report on the status of any audit findings relating to the federal awards that the pass-through entity provided.

A subrecipient may submit a copy of the reporting package to a pass-through entity to comply with this notification.

Requests for Copies

10.77 In response to a request by a federal agency or pass-through entity, auditees should submit the appropriate copies of the reporting package and, if requested, a copy of any management letters issued by the auditor.

Report Retention Requirements

10.78 Auditees are required to keep one copy of the data collection form and the reporting package on file for three years from the date of submission to the federal clearinghouse designated by the OMB. Pass-through entities should keep subrecipients' submissions on file for three years from the date of receipt.

Clearinghouse Address

10.79 The name and address of the federal clearinghouse currently designated by the OMB are as follows: Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th St., Jeffersonville, IN 47132.

Freedom of Information Act

10.80 In accordance with the principles of the Freedom of Information Act (U.S. Code title 5, section 552), audit agency and nonfederal reports issued to grantees and contractors are available, if they are requested, to members of the press and the general public, to the extent that the information contained in them is not subject to exemptions of the act that the cognizant agency for audit chooses to exercise. Accordingly, the auditor should not include names, social security numbers, other personal identification, or other potentially sensitive matters in either the body of the report or any attached schedules.

Chapter 11

PROGRAM-SPECIFIC AUDITS

11.1 A program-specific audit is an audit of an individual federal program (rather than a single audit of an entity's financial statements and federal programs). Section 235 of Circular A-133 provides guidance on program-specific audits.

Use of a Program-Specific Audit to Satisfy Circular A-133 Audit Requirements

11.2 Circular A-133 states that when an auditee expends federal awards under only one federal program (excluding research and development) and the federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit performed in accordance with section 235 of the circular.¹ Therefore, the auditor should determine whether there is a financial statement audit requirement before performing a program-specific audit. A program-specific audit may not be elected for research and development unless all federal awards expended were received from the same federal agency (or the same federal agency and the same pass-through entity) and that federal agency (or pass-through entity, in the case of a subrecipient) approves a program-specific audit in advance.

Program-Specific Audit Requirements

11.3 Circular A-133 requires program-specific audits to be subject to the following sections of Circular A-133 as they may apply to program-specific audits, unless contrary to the provisions of section 235 of Circular A-133, a federal program-specific audit guide, or the program's laws and regulations:

- Purpose; definitions; audit requirements; basis for determining the federal awards expended; subrecipient and vendor determinations; relation to other audit requirements (sections 100 through 215(b))
- Frequency of audits; sanctions; audit costs (sections 220 through 230)
- Auditee responsibilities; auditor selection (sections 300 through 305)
- Follow-up on audit findings (section 315)
- Submission of report (sections 320(f) through 320(j))
- Responsibilities of federal agencies and pass-through entities; management decisions (sections 400 through 405)
- Audit findings and audit working papers (sections 510 through 515)

Program-specific audits are also subject to other provisions, referred to in section 235 of the circular.

¹ An example of a situation where a program-specific audit would not be allowed would be a not-for-profit college that receives SFA (and no other federal awards). This is because the Higher Education Act of 1965, as amended, requires institutions that receive SFA to undergo an annual financial statement audit.

Availability of Program-Specific Audit Guides

11.4 In many cases, a federal agency's Office of Inspector General will have issued a program-specific audit guide that provides guidance on internal control, compliance requirements, suggested audit procedures, and audit reporting requirements for a particular federal program. The auditor should contact the Office of Inspector General of the federal agency to determine whether such a guide is available and current. When a current program-specific audit guide is available, the auditor should follow *Government Auditing Standards* and the guide when performing a program-specific audit. However, if there have been significant changes made to a program's compliance requirements and the related program-specific audit guide has not been updated with regard to the changes, the auditor should follow section 235 of Circular A-133 and the *Compliance Supplement* in lieu of an outdated guide. If a guide is current with regard to a program's compliance requirements but has not been updated to conform to current authoritative standards and guidance (such as current revisions of GAAS or *Government Auditing Standards*), the auditor should follow current applicable professional standards and guidance in lieu of the outdated or inconsistent standards and guidance in the guide.

11.5 When a program-specific audit guide is not available, the auditee and the auditor have basically the same responsibilities for the federal program as they have for an audit of a major program in a single audit as discussed in chapters 6 and 8 of this SOP.

Auditee's Responsibilities When a Program-Specific Audit Guide is Not Available

11.6 In addition to having the responsibilities included in the sections of Circular A-133 that are described in paragraph 11.3, the auditee is required to prepare the following:

- The financial statements for the federal program, which include, at a minimum, a schedule of expenditures of federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule
- A summary schedule of prior audit findings consistent with the requirements of section 315(b) of Circular A-133 (see paragraphs 10.68 through 10.70)
- If applicable, a corrective action plan consistent with the requirements of section 315(c) of the circular (see paragraphs 10.68 through 10.70)

Auditor's Responsibilities When a Program-Specific Audit Guide is Not Available

Audit Scope and Requirements

11.7 Circular A-133 requires the auditor to—

- Perform an audit of the financial statement(s) for the federal program in accordance with *Government Auditing Standards* (see chapter 4 of this SOP for guidance on financial statement audits). See paragraph 11.10 for a further discussion of *Government Auditing Standards*.

- Obtain an understanding of the internal control over compliance and perform tests of the internal control over compliance for the federal program, so that they are consistent with the requirements of section 500(c) of the circular for a major program (see chapter 8 of this SOP for guidance on the internal control considerations for major programs).
- Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program consistent with the requirements of section 500(d) of the circular for a major program (see chapter 6 of this SOP for guidance on the compliance-auditing considerations for major programs).
- Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings that has been prepared by the auditee, and when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding, report this as a current-year audit finding, in accordance with the requirements of section 500(e) of the circular (see paragraphs 10.69 through 10.70).

Auditor's Reports

Circular A-133 Requirements

11.8 Circular A-133 states that the auditor's reports may be in the form of either combined or separate reports and may be organized differently from the manner described below. The auditor's reports should state that the audit was conducted in accordance with GAAS, *Government Auditing Standards*, and Circular A-133 and should include the following:

- An opinion (or disclaimer of opinion) on whether the financial statement(s) of the federal program are presented fairly in all material respects in conformity with the stated accounting policies
- A report on the internal control related to the federal program, which describes the scope of the testing of the internal control and the results of the tests
- A report on compliance, which includes an opinion (or a disclaimer of opinion) on whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the federal program
- A schedule of findings and questioned costs for the federal program, which includes a summary of the auditor's results relative to the audit of the federal program in a format consistent with the requirements for the summary of auditor's results in section 505(d)(1) of the circular, as well as findings and questioned costs for federal awards consistent with the requirements of section 505(d)(3) of the circular (see paragraph 10.55 and 10.56)

Recommended Auditor's Reports

11.9 In an effort to make program-specific audit reporting understandable and to reduce the number of reports issued, this SOP recommends

that the following reports be issued for a program-specific audit (a) an opinion on the financial statement(s) of the federal program and (b) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under OMB Circular A-133. See the following paragraph for a discussion of the possible issuance of a third report to meet the reporting requirements of *Government Auditing Standards*. Illustrations of program-specific audit reports are included in examples 6 and 6a of appendix D.

Reporting in Accordance With Government Auditing Standards

11.10 If the financial statement(s) of the program only present the activity of the federal program, the auditor is not required to issue a separate report to meet the reporting requirements of *Government Auditing Standards*. This is because, in many cases, by definition the financial statements of the program consist only of the schedule of expenditures of federal awards. In this situation, examples 6 and 6a of appendix D, would meet the financial, compliance, and internal control over compliance reporting requirements of both *Government Auditing Standards* and Circular A-133. However, it should be noted that the auditor always has the option of issuing a separate *Government Auditing Standards* report (in addition to the two reports described in paragraph 11.9). Although it is not as common, the financial statement(s) of the federal program may present more than the program's activity (for example, a municipal sewer district issues financial statements that include both normal operations and the federal program activity related to a grant for the purpose of building a new sewage-treatment facility). In this situation, the auditor should issue a separate *Government Auditing Standards* report (example 2 or 2a of appendix D), and modify it so that it refers only to the financial statement(s) of the federal program.

Submission of Report

Timing of Submission

11.11 Circular A-133 requires the audit to be completed and the reporting required by sections 235(c)(2) and 235(c)(3) of the circular to be submitted, within the earlier of thirty days after the receipt of the auditor's reports or nine months after the end of the audit period, unless a longer period is agreed to in advance by the federal agency that provided the funding or unless a different period is specified in a program-specific audit guide.² Unless restricted by law or regulation, Circular A-133 requires the auditee to make copies of the report available for public inspection.

Submission When a Program-Specific Audit Guide is Available

11.12 When a program-specific audit guide is available, the auditee must submit to the federal clearinghouse designated by the OMB (see paragraph 10.79) the data collection form prepared in accordance with section 320(b) of the Circular (see paragraphs 10.71 through 10.73), as applicable for a program-

² It should be noted that Circular A-133 includes a delayed implementation date for deadlines for the submission of reports. For fiscal years beginning on or before June 30, 1998, the audit must be completed and the required reports submitted within the earlier of thirty days after the receipt of the auditor's report or thirteen months after the end of the audit period.

specific audit, and must also submit the reporting that is required by the program-specific audit guide which is to be retained as an archival copy. The auditee must also submit to the federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

Submission When a Program-Specific Audit Guide is Not Available

11.13 When a program-specific audit guide is not available, the reporting package for a program-specific audit consists of the following:

- The financial statement(s) of the federal program
- A summary schedule of prior audit findings (see paragraphs 10.68 through 10.70)
- A corrective action plan (see paragraphs 10.68 through 10.70)
- The auditor's report(s) described in paragraphs 11.8 through 11.10

11.14 The data collection form, as applicable to a program-specific audit, and one copy of the reporting package must be submitted to the federal clearinghouse designated by the OMB (see paragraph 10.79), to be retained as an archival copy. Furthermore, when the schedule of findings and questioned costs discloses audit findings or the summary schedule of prior audit findings reports the status of any audit findings, the auditee must submit one copy of the reporting package to the federal clearinghouse on behalf of the federal awarding agency or, in the case of a subrecipient, directly to the pass-through entity. When a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient is instead required to provide written notification to the pass-through entity, consistent with the requirements of section 320(e)(2) of Circular A-133 (see paragraph 10.76). A subrecipient may submit a copy of the reporting package to the pass-through entity, to comply with the notification requirement.

Appendix A

Single Audit Act Amendments of 1996

Public Law 104-156
104th Congress

An Act

July 5, 1996
[S. 1579]

To streamline and improve the effectiveness of chapter 75 of title 31, United States Code (commonly referred to as the "Single Audit Act").

Single Audit Act
Amendments of
1996.
31 USC 7501
note.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; PURPOSES.

(a) **SHORT TITLE**—This Act may be cited as the "Single Audit Act Amendments of 1996".

(b) **PURPOSES**—The purposes of this Act are to—

(1) promote sound financial management, including effective internal controls, with respect to Federal awards administered by non-Federal entities;

(2) establish uniform requirements for audits of Federal awards administered by non-Federal entities;

(3) promote the efficient and effective use of audit resources;

(4) reduce burdens on State and local governments, Indian tribes, and nonprofit organizations; and

(5) ensure that Federal departments and agencies, to the maximum extent practicable, rely upon and use audit work done pursuant to chapter 75 of title 31, United States Code (as amended by this Act).

SEC. 2. AMENDMENT TO TITLE 31, UNITED STATES CODE.

Chapter 75 of title 31, United States Code, is amended to read as follows:

"CHAPTER 75—REQUIREMENTS FOR SINGLE AUDITS

"Sec.

"7501. Definitions.

"7502. Audit requirements; exemptions.

"7503. Relation to other audit requirements.

"7504. Federal agency responsibilities and relations with non-Federal entities.

"7505. Regulations.

"7506. Monitoring responsibilities of the Comptroller General.

"7507. Effective date.

"§ 7501. Definitions

"(a) As used in this chapter, the term—

"(1) 'Comptroller General' means the Comptroller General of the United States;

"(2) 'Director' means the Director of the Office of Management and Budget;

"(3) 'Federal agency' has the same meaning as the term 'agency' in section 551(1) of title 5;

"(4) 'Federal awards' means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities;

Statements of Position

“(5) ‘Federal financial assistance’ means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property, cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, or other assistance, but does not include amounts received as reimbursement for services rendered to individuals in accordance with guidance issued by the Director;

“(6) ‘Federal program’ means all Federal awards to a non-Federal entity assigned a single number in the Catalog of Federal Domestic Assistance or encompassed in a group of numbers or other category as defined by the Director;

“(7) ‘generally accepted government auditing standards’ means the government auditing standards issued by the Comptroller General;

“(8) ‘independent auditor’ means—

“(A) an external State or local government auditor who meets the independence standards included in generally accepted government auditing standards; or

“(B) a public accountant who meets such independence standards;

“(9) ‘Indian tribe’ means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians;

“(10) ‘internal controls’ means a process, effected by an entity’s management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

“(A) Effectiveness and efficiency of operations.

“(B) Reliability of financial reporting.

“(C) Compliance with applicable laws and regulations;

“(11) ‘local government’ means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, any other instrumentality of local government and, in accordance with guidelines issued by the Director, a group of local governments;

“(12) ‘major program’ means a Federal program identified in accordance with risk-based criteria prescribed by the Director under this chapter, subject to the limitations described under subsection (b);

“(13) ‘non-Federal entity’ means a State, local government, or nonprofit organization;

“(14) ‘nonprofit organization’ means any corporation, trust, association, cooperative, or other organization that—

“(A) is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;

“(B) is not organized primarily for profit; and

“(C) uses net proceeds to maintain, improve, or expand the operations of the organization;

“(15) ‘pass-through entity’ means a non-Federal entity that provides Federal awards to a subrecipient to carry out a Federal program;

“(16) ‘program-specific audit’ means an audit of one Federal program;

“(17) ‘recipient’ means a non-Federal entity that receives awards directly from a Federal agency to carry out a Federal program;

“(18) ‘single audit’ means an audit, as described under section 7502(d), of a non-Federal entity that includes the entity’s financial statements and Federal awards;

“(19) ‘State’ means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or inter-state entity which has governmental functions, and any Indian tribe; and

“(20) ‘subrecipient’ means a non-Federal entity that receives Federal awards through another non-Federal entity to carry out a Federal program, but does not include an individual who receives financial assistance through such awards.

“(b) In prescribing risk-based program selection criteria for major programs, the Director shall not require more programs to be identified as major for a particular non-Federal entity, except as prescribed under subsection (c) or as provided under subsection (d), than would be identified if the major programs were defined as any program for which total expenditures of Federal awards by the non-Federal entity during the applicable year exceed—

“(1) the larger of \$30,000,000 or 0.15 percent of the non-Federal entity’s total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$10,000,000,000;

“(2) the larger of \$3,000,000, or 0.30 percent of the non-Federal entity’s total Federal expenditures, in the case of a non-Federal entity for which such total expenditures for all programs exceed \$100,000,000 but are less than or equal to \$10,000,000,000; or

“(3) the larger of \$300,000, or 3 percent of such total Federal expenditures for all programs, in the case of a non-Federal entity for which such total expenditures for all programs equal or exceed \$300,000 but are less than or equal to \$100,000,000.

“(c) When the total expenditures of a non-Federal entity’s major programs are less than 50 percent of the non-Federal entity’s total expenditures of all Federal awards (or such lower percentage as specified by the Director), the auditor shall select and test additional programs as major programs as necessary to achieve audit coverage of at least 50 percent of Federal expenditures by the non-Federal entity (or such lower percentage as specified by the Director), in accordance with guidance issued by the Director.

“(d) Loan or loan guarantee programs, as specified by the Director, shall not be subject to the application of subsection (b).

“§ 7502. Audit requirements; exemptions

“(a)(1)(A) Each non-Federal entity that expends a total amount of Federal awards equal to or in excess of \$300,000 or such other amount

specified by the Director under subsection (a)(3) in any fiscal year of such non-Federal entity shall have either a single audit or a program-specific audit made for such fiscal year in accordance with the requirements of this chapter.

“(B) Each such non-Federal entity that expends Federal awards under more than one Federal program shall undergo a single audit in accordance with the requirements of subsections (b) through (i) of this section and guidance issued by the Director under section 7505.

“(C) Each such non-Federal entity that expends awards under only one Federal program and is not subject to laws, regulations, or Federal award agreements that require a financial statement audit of the non-Federal entity, may elect to have a program-specific audit conducted in accordance with applicable provisions of this section and guidance issued by the Director under section 7505.

“(2)(A) Each non-Federal entity that expends a total amount of Federal awards of less than \$300,000 or such other amount specified by the Director under subsection (a)(3) in any fiscal year of such entity, shall be exempt for such fiscal year from compliance with—

“(i) the audit requirements of this chapter; and

“(ii) any applicable requirements concerning financial audits contained in Federal statutes and regulations governing programs under which such Federal awards are provided to that non-Federal entity.

“(B) The provisions of subparagraph (A)(ii) of this paragraph shall not exempt a non-Federal entity from compliance with any provision of a Federal statute or regulation that requires such non-Federal entity to maintain records concerning Federal awards provided to such non-Federal entity or that permits a Federal agency, pass-through entity, or the Comptroller General access to such records.

“(3) Every 2 years, the Director shall review the amount for requiring audits prescribed under paragraph (1)(A) and may adjust such dollar amount consistent with the purposes of this chapter, provided the Director does not make such adjustments below \$300,000.

“(b)(1) Except as provided in paragraphs (2) and (3), audits conducted pursuant to this chapter shall be conducted annually.

“(2) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(3) Any nonprofit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this chapter biennially. Audits conducted biennially under the provisions of this paragraph shall cover both years within the biennial period.

“(c) Each audit conducted pursuant to subsection (a) shall be conducted by an independent auditor in accordance with generally

accepted government auditing standards, except that, for the purposes of this chapter, performance audits shall not be required except as authorized by the Director.

“(d) Each single audit conducted pursuant to subsection (a) for any fiscal year shall—

“(1) cover the operations of the entire non-Federal entity; or

“(2) at the option of such non-Federal entity such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and organizational unit, which shall be considered to be a non-Federal entity.

“(e) The auditor shall—

“(1) determine whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles;

“(2) determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole;

“(3) with respect to internal controls pertaining to the compliance requirements for each major program—

“(A) obtain an understanding of such internal controls;

“(B) assess control risk; and

“(C) perform tests of controls unless the controls are deemed to be ineffective; and

“(4) determine whether the non-Federal entity has complied with the provisions of laws, regulations, and contracts or grants pertaining to Federal awards that have a direct and material effect on each major program.

“(f)(1) Each Federal agency which provides Federal awards to a recipient shall—

“(A) provide such recipient the program names (and any identifying numbers) from which such awards are derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter; and

“(B) review the audit of a recipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the recipient by the Federal agency.

“(2) Each pass-through entity shall—

“(A) provide such subrecipient the program names (and any identifying numbers) from which such assistance is derived, and the Federal requirements which govern the use of such awards and the requirements of this chapter;

“(B) monitor the subrecipient’s use of Federal awards through site visits, limited scope audits, or other means;

“(C) review the audit of a subrecipient as necessary to determine whether prompt and appropriate corrective action has been taken with respect to audit findings, as defined by the Director, pertaining to Federal awards provided to the subrecipient by the pass-through entity; and

Statements of Position

“(D) require each of its subrecipients of Federal awards to permit, as a condition of receiving Federal awards, the independent auditor of the pass-through entity to have such access to the subrecipient’s records and financial statements as may be necessary for the pass-through entity to comply with this chapter.

“(g)(1) The auditor shall report on the results of any audit conducted pursuant to this section, in accordance with guidance issued by the Director. Reports.

“(2) When reporting on any single audit, the auditor shall include a summary of the auditor’s results regarding the non-Federal entity’s financial statements, internal controls, and compliance with laws and regulations.

“(h) The non-Federal entity shall transmit the reporting package, which shall include the non-Federal entity’s financial statements, schedule of expenditures of Federal awards, corrective action plan defined under subsection (i), and auditor’s reports developed pursuant to this section, to a Federal clearinghouse designated by the Director, and make it available for public inspection within the earlier of—

“(1) 30 days after receipt of the auditor’s report; or

“(2)(A) for a transition period of at least 2 years after the effective date of the Single Audit Act Amendments of 1996, as established by the Director, 13 months after the end of the period audited; or

“(B) for fiscal years beginning after the period specified in subparagraph (A), 9 months after the end of the period audited, or within a longer time frame authorized by the Federal agency, determined under criteria issued under section 7504, when the 9-month time frame would place an undue burden on the non-Federal entity.

“(i) If an audit conducted pursuant to this section discloses any audit findings, as defined by the Director, including material noncompliance with individual compliance requirements for a major program by, or reportable conditions in the internal controls of, the non-Federal entity with respect to the matters described in subsection (e), the non-Federal entity shall submit to Federal officials designated by the Director, a plan for corrective action to eliminate such audit findings or reportable conditions or a statement describing the reasons that corrective action is not necessary. Such plan shall be consistent with the audit resolution standard promulgated by the Comptroller General (as part of the standards for internal controls in the Federal Government) pursuant to section 3512(c).

“(j) The Director may authorize pilot projects to test alternative methods of achieving the purposes of this chapter. Such pilot projects may begin only after consultation with the Chair and Ranking Minority Member of the Committee on Governmental Affairs of the Senate and the Chair and Ranking Minority Member of the Committee on Government Reform and Oversight of the House of Representatives.

§ 7503. Relation to other audit requirements

“(a) An audit conducted in accordance with this chapter shall be in lieu of any financial audit of Federal awards which a non-Federal entity is required to undergo under any other Federal law or regulation. To the extent that such audit provides a Federal agency with the information it requires to carry out its responsibilities under Federal

law or regulation, a Federal agency shall rely upon and use that information.

“(b) Notwithstanding subsection (a), a Federal agency may conduct or arrange for additional audits which are necessary to carry out its responsibilities under Federal law or regulation. The provisions of this chapter do not authorize any non-Federal entity (or subrecipient thereof) to constrain, in any manner, such agency from carrying out or arranging for such additional audits, except that the Federal agency shall plan such audits to not be duplicative of other audits of Federal awards.

“(c) The provisions of this chapter do not limit the authority of Federal agencies to conduct, or arrange for the conduct of, audits and evaluations of Federal awards, nor limit the authority of any Federal agency Inspector General or other Federal official.

“(d) Subsection (a) shall apply to a non-Federal entity which undergoes an audit in accordance with this chapter even though it is not required by section 7502(a) to have such an audit.

“(e) A Federal agency that provides Federal awards and conducts or arranges for audits of non-Federal entities receiving such awards that are in addition to the audits of non-Federal entities conducted pursuant to this chapter shall, consistent with other applicable law, arrange for funding the full cost of such additional audits. Any such additional audits shall be coordinated with the Federal agency determined under criteria issued under section 7504 to preclude duplication of the audits conducted pursuant to this chapter or other additional audits.

“(f) Upon request by a Federal agency or the Comptroller General, any independent auditor conducting an audit pursuant to this chapter shall make the auditor’s working papers available to the Federal agency or the Comptroller General as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this chapter. Such access to auditor’s working papers shall include the right to obtain copies.

“§ 7504. Federal agency responsibilities and relations with non-Federal entities

“(a) Each Federal agency shall, in accordance with guidance issued by the Director under section 7505, with regard to Federal awards provided by the agency—

“(1) monitor non-Federal entity use of Federal awards, and

“(2) assess the quality of audits conducted under this chapter for audits of entities for which the agency is the single Federal agency determined under subsection (b).

“(b) Each non-Federal entity shall have a single Federal agency, determined in accordance with criteria established by the Director, to provide the non-Federal entity with technical assistance and assist with implementation of this chapter.

“(c) The Director shall designate a Federal clearinghouse to—

“(1) receive copies of all reporting packages developed in accordance with this chapter;

“(2) identify recipients that expend \$300,000 or more in Federal awards or such other amount specified by the Director under section 7502(a)(3) during the recipient’s fiscal year but did not undergo an audit in accordance with this chapter; and

“(3) perform analyses to assist the Director in carrying out responsibilities under this chapter.

“§ 7505. Regulations

“(a) The Director, after consultation with the Comptroller General, and appropriate officials from Federal, State, and local governments and nonprofit organizations shall prescribe guidance to implement this chapter. Each Federal agency shall promulgate such amendments to its regulations as may be necessary to conform such regulations to the requirements of this chapter and of such guidance.

“(b)(1) The guidance prescribed pursuant to subsection (a) shall include criteria for determining the appropriate charges to Federal awards for the cost of audits. Such criteria shall prohibit a non-Federal entity from charging to any Federal awards—

“(A) the cost of any audit which is—

“(i) not conducted in accordance with this chapter; or

“(ii) conducted in accordance with this chapter when expenditures of Federal awards are less than amounts cited in section 7502(a)(1)(A) or specified by the Director under section 7502(a)(3), except that the Director may allow the cost of limited scope audits to monitor subrecipients in accordance with section 7502(f)(2)(B); and

“(B) more than a reasonably proportionate share of the cost of any such audit that is conducted in accordance with this chapter.

“(2) The criteria prescribed pursuant to paragraph (1) shall not, in the absence of documentation demonstrating a higher actual cost, permit the percentage of the cost of audits performed pursuant to this chapter charged to Federal awards, to exceed the ratio of total Federal awards expended by such non-Federal entity during the applicable fiscal year or years, to such non-Federal entity's total expenditures during such fiscal year or years.

“(c) Such guidance shall include such provisions as may be necessary to ensure that small business concerns and business concerns owned and controlled by socially and economically disadvantaged individuals will have the opportunity to participate in the performance of contracts awarded to fulfill the audit requirements of this chapter.

“§ 7506. Monitoring responsibilities of the Comptroller General

“(a) The Comptroller General shall review provisions requiring financial audits of non-Federal entities that receive Federal awards that are contained in bills and resolutions reported by the committees of the Senate and the House of Representatives.

“(b) If the Comptroller General determines that a bill or resolution contains provisions that are inconsistent with the requirements of this chapter, the Comptroller General shall, at the earliest practicable date, notify in writing—

“(1) the committee that reported such bill or resolution; and

“(2)(A) the Committee on Governmental Affairs of the Senate (in the case of a bill or resolution reported by a committee of the Senate); or

“(B) the Committee on Government Reform and Oversight of the House of Representatives (in the case of a bill or resolution reported by a committee of the House of Representatives).

“§ 7507. Effective date

“This chapter shall apply to any non-Federal entity with respect to any of its fiscal years which begin after June 30, 1996.”.

31 USC 7501
note.

SEC. 3. TRANSITIONAL APPLICATION

Subject to section 7507 of title 31, United States Code (as amended by section 2 of this Act) the provisions of chapter 75 of such title (before amendment by section 2 of this Act) shall continue to apply to any State or local government with respect to any of its fiscal years beginning before July 1, 1996.

Approved July 5, 1996.

LEGISLATIVE HISTORY—S. 1579 (H.R. 3184):

HOUSE REPORTS: No. 104–607 accompanying H.R. 3184 (Comm. on Government Reform and Oversight).

SENATE REPORTS: No. 104–266 (Comm. On Governmental Affairs).

CONGRESSIONAL RECORD, Vol. 142 (1996):

June 14, considered and passed Senate.

June 18, considered and passed House.

WEEKLY COMPILATION OF PRESIDENTIAL DOCUMENTS, Vol. 32 (1996):
July 5, Presidential statement.

Appendix B

OMB Circular A-133, Audits of States, Local Governments, and Non-Profit Organizations

Franklin D. Raines,
Director

1. OMB rescinds Circular A-128 July 30, 1997
2. OMB revises Circular A-133 to read as follows:

[Circular No. A-133—Revised]

To the Heads of Executive Departments and Establishments

SUBJECT: Audits of States, Local Governments, and Non-Profit Organizations.

1. *Purpose.* This Circular is issued pursuant to the Single Audit Act of 1984, P.L. 98-502, and the Single Audit Act Amendments of 1996, P.L. 104-156. It sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of States, local governments, and non-profit organizations expending Federal awards.

2. *Authority.* Circular A-133 is issued under the authority of sections 503, 1111, and 7501 *et seq.* of title 31, United States Code, and Executive Orders 8248 and 11541.

3. *Rescission and Supersession.* This Circular rescinds Circular A-128, "Audits of State and Local Governments," issued April 12, 1985, and supersedes the prior Circular A-133, "Audits of Institutions of Higher Education and Other Non-Profit Institutions," issued April 22, 1996. For effective dates, see paragraph 10.

4. *Policy.* Except as provided herein, the standards set forth in this Circular shall be applied by all Federal agencies. If any statute specifically prescribes policies or specific requirements that differ from the standards provided herein, the provisions of the subsequent statute shall govern.

Federal agencies shall apply the provisions of the sections of this Circular to non-Federal entities, whether they are recipients expending Federal awards received directly from Federal awarding agencies, or are subrecipients expending Federal awards received from a pass-through entity (a recipient or another subrecipient).

This Circular does not apply to non-U.S. based entities expending Federal awards received either directly as a recipient or indirectly as a subrecipient.

5. *Definitions.* The definitions of key terms used in this Circular are contained in §___105 in the Attachment to this Circular.

6. *Required Action.* The specific requirements and responsibilities of Federal agencies and non-Federal entities are set forth in the Attachment to this

Circular. Federal agencies making awards to non-Federal entities, either directly or indirectly, shall adopt the language in the Circular in codified regulations as provided in Section 10 (below), unless different provisions are required by Federal statute or are approved by the Office of Management and Budget (OMB).

7. OMB Responsibilities. OMB will review Federal agency regulations and implementation of this Circular, and will provide interpretations of policy requirements and assistance to ensure uniform, effective and efficient implementation.

8. Information Contact. Further information concerning Circular A-133 may be obtained by contacting the Financial Standards and Reporting Branch, Office of Federal Financial Management, Office of Management and Budget, Washington, DC 20503, telephone (202) 395-3993.

9. Review Date. This Circular will have a policy review three years from the date of issuance.

10. Effective Dates. The standards set forth in §__.400 of the Attachment to this Circular, which apply directly to Federal agencies, shall be effective July 1, 1996, and shall apply to audits of fiscal years beginning after June 30, 1996, except as otherwise specified in §__.400(a).

The standards set forth in this Circular that Federal agencies shall apply to non-Federal entities shall be adopted by Federal agencies in codified regulations not later than 60 days after publication of this final revision in the **Federal Register**, so that they will apply to audits of fiscal years beginning after June 30, 1996, with the exception that §__.305(b) of the Attachment applies to audits of fiscal years beginning after June 30, 1998. The requirements of Circular A-128, although the Circular is rescinded, and the 1990 version of Circular A-133 remain in effect for audits of fiscal years beginning on or before June 30, 1996.

Franklin D. Raines,
Director.

Attachment

PART__—AUDITS OF STATES, LOCAL GOVERNMENTS, AND NON-PROFIT ORGANIZATIONS**Subpart A—General**

Sec.

__.100 Purpose.

__.105 Definitions.

Subpart B—Audits

__.200 Audit requirements.

__.205 Basis for determining Federal awards expended.

__.210 Subrecipient and vendor determinations.

__.215 Relation to other audit requirements.

__.220 Frequency of audits.

__.225 Sanctions.

__.230 Audit costs.

__.235 Program-specific audits.

Subpart C—Auditees

__.300 Auditee responsibilities.

__.305 Auditor selection.

__.310 Financial statements.

__.315 Audit findings follow-up.

__.320 Report submission.

Subpart D—Federal Agencies and Pass-Through Entities

__.400 Responsibilities.

__.405 Management decision.

Subpart E—Auditors

__.500 Scope of audit.

__.505 Audit reporting.

__.510 Audit findings.

__.515 Audit working papers.

__.520 Major program determination.

__.525 Criteria for Federal program risk.

__.530 Criteria for a low-risk auditee.

Appendix A to Part__—Data Collection Form (Form SF-SAC)**Appendix B to Part__—Circular A-133 Compliance Supplement****Subpart A—General**

§__.100 Purpose.

This part sets forth standards for obtaining consistency and uniformity among Federal agencies for the audit of non-Federal entities expending Federal awards.

§__.105 Definitions.

Auditee means any non-Federal entity that expends Federal awards which must be audited under this part.

Auditor means an auditor, that is a public accountant or a Federal, State or local government audit organization, which meets the general standards specified in generally accepted government auditing standards (GAGAS). The term auditor does not include internal auditors of non-profit organizations.

Audit finding means deficiencies which the auditor is required by §__.510(a) to report in the schedule of findings and questioned costs.

CFDA number means the number assigned to a Federal program in the *Catalog of Federal Domestic Assistance (CFDA)*.

Cluster of programs means a grouping of closely related programs that share common compliance requirements. The types of clusters of programs are research and development (R&D), student financial aid (SFA), and other clusters. "Other clusters" are as defined by the Office of Management and Budget (OMB) in the compliance supplement or as designated by a State for Federal awards the State provides to its subrecipients that meet the definition of a cluster of programs. When designating an "other cluster," a State shall identify the Federal awards included in the cluster and advise the subrecipients of compliance requirements applicable to the cluster, consistent with §__.400(d)(1) and §__.400(d)(2), respectively. A cluster of programs shall be considered as one program for determining major programs, as described in §__.520, and, with the exception of R&D as described in §__.200(c), whether a program-specific audit may be elected.

Cognizant agency for audit means the Federal agency designated to carry out the responsibilities described in §__.400(a).

Compliance supplement refers to the *Circular A-133 Compliance Supplement*, included as Appendix B to Circular A-133, or such documents as OMB or its designee may issue to replace it. This document is available from the Government Printing Office, Superintendent of Documents, Washington, DC 20402-9325.

Corrective action means action taken by the auditee that:

- (1) Corrects identified deficiencies;
- (2) Produces recommended improvements; or
- (3) Demonstrates that audit findings are either invalid or do not warrant auditee action.

Federal agency has the same meaning as the term *agency* in Section 551(1) of title 5, United States Code.

Federal award means Federal financial assistance and Federal cost-reimbursement contracts that non-Federal entities receive directly from Federal awarding agencies or indirectly from pass-through entities. It does not include procurement contracts, under grants or contracts, used to buy goods or services from vendors. Any audits of such vendors shall be covered by the terms and conditions of the contract. Contracts to operate Federal Government owned, contractor operated facilities (GOCOs) are excluded from the requirements of this part.

Federal awarding agency means the Federal agency that provides an award directly to the recipient.

Federal financial assistance means assistance that non-Federal entities receive or administer in the form of grants, loans, loan guarantees, property (including donated surplus property), cooperative agreements, interest subsidies, insurance, food commodities, direct appropriations, and other assistance, but does not include amounts received as reimbursement for services rendered to individuals as described in §__.205(h) and §__.205(i).

Federal program means:

- (1) All Federal awards to a non-Federal entity assigned a single number in the CFDA.
- (2) When no CFDA number is assigned, all Federal awards from the same agency made for the same purpose should be combined and considered one program.
- (3) Notwithstanding paragraphs (1) and (2) of this definition, a cluster of programs. The types of clusters of programs are:
 - (i) Research and development (R&D);
 - (ii) Student financial aid (SFA); and
 - (iii) "Other clusters," as described in the definition of cluster of programs in this section.

GAGAS means generally accepted government auditing standards issued by the Comptroller General of the United States, which are applicable to financial audits.

Generally accepted accounting principles has the meaning specified in generally accepted auditing standards issued by the American Institute of Certified Public Accountants (AICPA).

Indian tribe means any Indian tribe, band, nation, or other organized group or community, including any Alaskan Native village or regional or village corporation (as defined in, or established under, the Alaskan Native Claims Settlement Act) that is recognized by the United States as eligible for the special programs and services provided by the United States to Indians because of their status as Indians.

Internal control means a process, effected by an entity's management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- (1) Effectiveness and efficiency of operations;
- (2) Reliability of financial reporting; and
- (3) Compliance with applicable laws and regulations.

Internal control pertaining to the compliance requirements for Federal programs (Internal control over Federal programs) means a process—effected by an entity's management and other personnel—designed to provide reasonable assurance regarding the achievement of the following objectives for Federal programs:

- (1) Transactions are properly recorded and accounted for to:
 - (i) Permit the preparation of reliable financial statements and Federal reports;

- (ii) Maintain accountability over assets; and
 - (iii) Demonstrate compliance with laws, regulations, and other compliance requirements;
- (2) Transactions are executed in compliance with:
- (i) Laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on a Federal program; and
 - (ii) Any other laws and regulations that are identified in the compliance supplement; and
- (3) Funds, property, and other assets are safeguarded against loss from unauthorized use or disposition.

Loan means a Federal loan or loan guarantee received or administered by a non-Federal entity.

Local government means any unit of local government within a State, including a county, borough, municipality, city, town, township, parish, local public authority, special district, school district, intrastate district, council of governments, and any other instrumentality of local government.

Major program means a Federal program determined by the auditor to be a major program in accordance with §___.520 or a program identified as a major program by a Federal agency or pass-through entity in accordance with §___.215(c).

Management decision means the evaluation by the Federal awarding agency or pass-through entity of the audit findings and corrective action plan and the issuance of a written decision as to what corrective action is necessary.

Non-Federal entity means a State, local government, or non-profit organization.

Non-profit organization means:

- (1) any corporation, trust, association, cooperative, or other organization that:
 - (i) Is operated primarily for scientific, educational, service, charitable, or similar purposes in the public interest;
 - (ii) Is not organized primarily for profit; and
 - (iii) Uses its net proceeds to maintain, improve, or expand its operations; and
- (2) The term *non-profit organization* includes non-profit institutions of higher education and hospitals.

OMB means the Executive Office of the President, Office of Management and Budget.

Oversight agency for audit means the Federal awarding agency that provides the predominant amount of direct funding to a recipient not assigned a cognizant agency for audit. When there is no direct funding, the Federal agency with the predominant indirect funding shall assume the oversight responsibilities. The duties of the oversight agency for audit are described in §___.400(b).

Pass-through entity means a non-Federal entity that provides a Federal award to a subrecipient to carry out a Federal program.

Program-specific audit means an audit of one Federal program as provided for in §__.200(c) and §__.235.

Questioned cost means a cost that is questioned by the auditor because of an audit finding:

- (1) Which resulted from a violation or possible violation of a provision of a law, regulation, contract, grant, cooperative agreement, or other agreement or document governing the use of Federal funds, including funds used to match Federal funds;
- (2) Where the costs, at the time of the audit, are not supported by adequate documentation; or
- (3) Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

Recipient means a non-Federal entity that expends Federal awards received directly from a Federal awarding agency to carry out a Federal program.

Research and development (R&D) means all research activities, both basic and applied, and all development activities that are performed by a non-Federal entity. *Research* is defined as a systematic study directed toward fuller scientific knowledge or understanding of the subject studied. The term research also includes activities involving the training of individuals in research techniques where such activities utilize the same facilities as other research and development activities and where such activities are not included in the instruction function. *Development* is the systematic use of knowledge and understanding gained from research directed toward the production of useful materials, devices, systems, or methods, including design and development of prototypes and processes.

Single audit means an audit which includes both the entity's financial statements and the Federal awards as described in §__.500.

State means any State of the United States, the District of Columbia, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, and the Trust Territory of the Pacific Islands, any instrumentality thereof, any multi-State, regional, or interstate entity which has governmental functions, and any Indian tribe as defined in this section.

Student Financial Aid (SFA) includes those programs of general student assistance, such as those authorized by Title IV of the Higher Education Act of 1965, as amended, (20 U.S.C. 1070 *et seq.*) which is administered by the U.S. Department of Education, and similar programs provided by other Federal agencies. It does not include programs which provide fellowships or similar Federal awards to students on a competitive basis, or for specified studies or research.

Subrecipient means a non-Federal entity that expends Federal awards received from a pass-through entity to carry out a Federal program, but does not include an individual that is a beneficiary of such a program. A subrecipient may also be a recipient of other Federal awards directly from a Federal awarding agency. Guidance on distinguishing between a subrecipient and a vendor is provided in §__.210.

Types of compliance requirements refers to the types of compliance requirements listed in the compliance supplement. Examples include: activities allowed or unallowed; allowable costs/cost principles; cash management; eligibility; matching, level of effort, earmarking; and, reporting.

Vendor means a dealer, distributor, merchant, or other seller providing goods or services that are required for the conduct of a Federal program. These goods or services may be for an organization's own use or for the use of beneficiaries of the Federal program. Additional guidance on distinguishing between a subrecipient and a vendor is provided in §__.210.

Subpart B—Audits

§__.200 Audit requirements.

(a) *Audit required.* Non-Federal entities that expend \$300,000 or more in a year in Federal awards shall have a single or program-specific audit conducted for that year in accordance with the provisions of this part. Guidance on determining Federal awards expended is provided in §__.205.

(b) *Single audit.* Non-Federal entities that expend \$300,000 or more in a year in Federal awards shall have a single audit conducted in accordance with §__.500 except when they elect to have a program-specific audit conducted in accordance with paragraph (c) of this section.

(c) *Program-specific audit election.* When an auditee expends Federal awards under only one Federal program (excluding R&D) and the Federal program's laws, regulations, or grant agreements do not require a financial statement audit of the auditee, the auditee may elect to have a program-specific audit conducted in accordance with §__.235. A program-specific audit may not be elected for R&D unless all of the Federal awards expended were received from the same Federal agency, or the same Federal agency and the same pass-through entity, and that Federal agency, or pass-through entity in the case of a subrecipient, approves in advance a program-specific audit.

(d) *Exemption when Federal awards expended are less than \$300,000.* Non-Federal entities that expend less than \$300,000 a year in Federal awards are exempt from Federal audit requirements for that year, except as noted in §__.215(a), but records must be available for review or audit by appropriate officials of the Federal agency, pass-through entity, and General Accounting Office (GAO).

(e) *Federally Funded Research and Development Centers (FFRDC).* Management of an auditee that owns or operates a FFRDC may elect to treat the FFRDC as a separate entity for purposes of this part.

§__.205 Basis for determining Federal awards expended.

(a) *Determining Federal awards expended.* The determination of when an award is expended should be based on when the activity related to the award occurs. Generally, the activity pertains to events that require the non-Federal entity to comply with laws, regulations, and the provisions of contracts or grant agreements, such as: expenditure/expense transactions associated with grants, cost-reimbursement contracts, cooperative agreements, and direct appropriations; the disbursement of funds passed through to subrecipients; the use of loan proceeds under loan and loan guarantee programs; the receipt of property; the receipt of surplus property; the receipt or use of program income; the distribution or consumption of food commodities; the disbursement of amounts entitling the non-Federal entity to an interest subsidy; and, the period when insurance is in force.

(b) *Loan and loan guarantees (loans).* Since the Federal Government is at risk for loans until the debt is repaid, the following guidelines shall be used to

calculate the value of Federal awards expended under loan programs, except as noted in paragraphs (c) and (d) of this section:

- (1) Value of new loans made or received during the fiscal year; plus
- (2) Balance of loans from previous years for which the Federal Government imposes continuing compliance requirements; plus
- (3) Any interest subsidy, cash, or administrative cost allowance received.

(c) *Loan and loan guarantees (loans) at institutions of higher education.* When loans are made to students of an institution of higher education but the institution does not make the loans, then only the value of loans made during the year shall be considered Federal awards expended in that year. The balance of loans for previous years is not included as Federal awards expended because the lender accounts for the prior balances.

(d) *Prior loan and loan guarantees (loans).* Loans, the proceeds of which were received and expended in prior-years, are not considered Federal awards expended under this part when the laws, regulations, and the provisions of contracts or grant agreements pertaining to such loans impose no continuing compliance requirements other than to repay the loans.

- (e) *Endowment funds.* The cumulative balance of Federal awards for endowment funds which are federally restricted are considered awards expended in each year in which the funds are still restricted.

(f) *Free rent.* Free rent received by itself is not considered a Federal award expended under this part. However, free rent received as part of an award to carry out a Federal program shall be included in determining Federal awards expended and subject to audit under this part.

(g) *Valuing non-cash assistance.* Federal non-cash assistance, such as free rent, food stamps, food commodities, donated property, or donated surplus property, shall be valued at fair market value at the time of receipt or the assessed value provided by the Federal agency.

(h) *Medicare.* Medicare payments to a non-Federal entity for providing patient care services to Medicare eligible individuals are not considered Federal awards expended under this part.

(i) *Medicaid.* Medicaid payments to a subrecipient for providing patient care services to Medicaid eligible individuals are not considered Federal awards expended under this part unless a State requires the funds to be treated as Federal awards expended because reimbursement is on a cost-reimbursement basis.

(j) *Certain loans provided by the National Credit Union Administration.* For purposes of this part, loans made from the National Credit Union Share Insurance Fund and the Central Liquidity Facility that are funded by contributions from insured institutions are not considered Federal awards expended.

§__210 Subrecipient and vendor determinations.

(a) *General.* An auditee may be a recipient, a subrecipient, and a vendor. Federal awards expended as a recipient or a subrecipient would be subject to audit under this part. The payments received for goods or services provided as a vendor would not be considered Federal awards. The guidance in paragraphs (b) and (c) of this section should be considered in determining whether payments constitute a Federal award or a payment for goods and services.

(b) *Federal award.* Characteristics indicative of a Federal award received by a subrecipient are when the organization:

- (1) Determines who is eligible to receive what Federal financial assistance;
- (2) Has its performance measured against whether the objectives of the Federal program are met;
- (3) Has responsibility for programmatic decision making;
- (4) Has responsibility for adherence to applicable Federal program compliance requirements; and
- (5) Uses the Federal funds to carry out a program of the organization as compared to providing goods or services for a program of the pass-through entity.

(c) *Payment for goods and services.* Characteristics indicative of a payment for goods and services received by a vendor are when the organization:

- (1) Provides the goods and services within normal business operations;
- (2) Provides similar goods or services to many different purchasers;
- (3) Operates in a competitive environment;
- (4) Provides goods or services that are ancillary to the operation of the Federal program; and
- (5) Is not subject to compliance requirements of the Federal program.

(d) *Use of judgment in making determination.* There may be unusual circumstances or exceptions to the listed characteristics. In making the determination of whether a subrecipient or vendor relationship exists, the substance of the relationship is more important than the form of the agreement. It is not expected that all of the characteristics will be present and judgment should be used in determining whether an entity is a subrecipient or vendor.

(e) *For-profit subrecipient.* Since this part does not apply to for-profit subrecipients, the pass-through entity is responsible for establishing requirements, as necessary, to ensure compliance by for-profit subrecipients. The contract with the for-profit subrecipient should describe applicable compliance requirements and the for-profit subrecipient's compliance responsibility. Methods to ensure compliance for Federal awards made to for-profit subrecipients may include pre-award audits, monitoring during the contract, and post-award audits.

(f) *Compliance responsibility for vendors.* In most cases, the auditee's compliance responsibility for vendors is only to ensure that the procurement, receipt, and payment for goods and services comply with laws, regulations, and the provisions of contracts or grant agreements. Program compliance requirements normally do not pass through to vendors. However, the auditee is responsible for ensuring compliance for vendor transactions which are structured such that the vendor is responsible for program compliance or the vendor's records must be reviewed to determine program compliance. Also, when these vendor transactions relate to a major program, the scope of the audit shall include determining whether these transactions are in compliance with laws, regulations, and the provisions of contracts or grant agreements.

§__.215 Relation to other audit requirements.

(a) *Audit under this part in lieu of other audits.* An audit made in accordance with this part shall be in lieu of any financial audit required under individual

Federal awards. To the extent this audit meets a Federal agency's needs, it shall rely upon and use such audits. The provisions of this part neither limit the authority of Federal agencies, including their Inspectors General, or GAO to conduct or arrange for additional audits (e.g., financial audits, performance audits, evaluations, inspections, or reviews) nor authorize any auditee to constrain Federal agencies from carrying out additional audits. Any additional audits shall be planned and performed in such a way as to build upon work performed by other auditors.

(b) *Federal agency to pay for additional audits.* A Federal agency that conducts or contracts for additional audits shall, consistent with other applicable laws and regulations, arrange for funding the full cost of such additional audits.

(c) *Request for a program to be audited as a major program.* A Federal agency may request an auditee to have a particular Federal program audited as a major program in lieu of the Federal agency conducting or arranging for the additional audits. To allow for planning, such requests should be made at least 180 days prior to the end of the fiscal year to be audited. The auditee, after consultation with its auditor, should promptly respond to such request by informing the Federal agency whether the program would otherwise be audited as a major program using the risk-based audit approach described in §___.520 and, if not, the estimated incremental cost. The Federal agency shall then promptly confirm to the auditee whether it wants the program audited as a major program. If the program is to be audited as a major program based upon this Federal agency request, and the Federal agency agrees to pay the full incremental costs, then the auditee shall have the program audited as a major program. A pass-through entity may use the provisions of this paragraph for a subrecipient.

§___.220 Frequency of audits.

Except for the provisions for biennial audits provided in paragraphs (a) and (b) of this section, audits required by this part shall be performed annually. Any biennial audit shall cover both years within the biennial period.

- (a) A State or local government that is required by constitution or statute, in effect on January 1, 1987, to undergo its audits less frequently than annually, is permitted to undergo its audits pursuant to this part biennially. This requirement must still be in effect for the biennial period under audit.
- (b) Any non-profit organization that had biennial audits for all biennial periods ending between July 1, 1992, and January 1, 1995, is permitted to undergo its audits pursuant to this part biennially.

§___.225 Sanctions.

No audit costs may be charged to Federal awards when audits required by this part have not been made or have been made but not in accordance with this part. In cases of continued inability or unwillingness to have an audit conducted in accordance with this part, Federal agencies and pass-through entities shall take appropriate action using sanctions such as:

- (a) Withholding a percentage of Federal awards until the audit is completed satisfactorily;
- (b) Withholding or disallowing overhead costs;
- (c) Suspending Federal awards until the audit is conducted; or
- (d) Terminating the Federal award.

§___.230 Audit costs.

(a) *Allowable costs.* Unless prohibited by law, the cost of audits made in accordance with the provisions of this part are allowable charges to Federal awards. The charges may be considered a direct cost or an allocated indirect cost, as determined in accordance with the provisions of applicable OMB cost principles circulars, the Federal Acquisition Regulation (FAR) (48 CFR parts 30 and 31), or other applicable cost principles or regulations.

(b) *Unallowable costs.* A non-Federal entity shall not charge the following to a Federal award:

- (1) The cost of any audit under the Single Audit Act Amendments of 1996 (31 U.S.C. 7501 *et seq.*) not conducted in accordance with this part.
- (2) The cost of auditing a non-Federal entity which has Federal awards expended of less than \$300,000 per year and is thereby exempted under §___.200(d) from having an audit conducted under this part. However, this does not prohibit a pass-through entity from charging Federal awards for the cost of limited scope audits to monitor its subrecipients in accordance with §___.400(d)(3), provided the subrecipient does not have a single audit. For purposes of this part, limited scope audits only include agreed-upon procedures engagements conducted in accordance with either the AICPA's generally accepted auditing standards or attestation standards, that are paid for and arranged by a pass-through entity and address only one or more of the following types of compliance requirements: activities allowed or unallowed; allowable costs/cost principles; eligibility; matching, level of effort, earmarking; and, reporting.

§___.235 Program-specific audits.

(a) *Program-specific audit guide available.* In many cases, a program-specific audit guide will be available to provide specific guidance to the auditor with respect to internal control, compliance requirements, suggested audit procedures, and audit reporting requirements. The auditor should contact the Office of Inspector General of the Federal agency to determine whether such a guide is available. When a current program-specific audit guide is available, the auditor shall follow GAGAS and the guide when performing a program-specific audit.

(b) *Program-specific audit guide not available.* (1) When a program-specific audit guide is not available, the auditee and auditor shall have basically the same responsibilities for the Federal program as they would have for an audit of a major program in a single audit.

- (2) The auditee shall prepare the financial statement(s) for the Federal program that includes, at a minimum, a schedule of expenditures of Federal awards for the program and notes that describe the significant accounting policies used in preparing the schedule, a summary schedule of prior audit findings consistent with the requirements of §___.315(b), and a corrective action plan consistent with the requirements of §___.315(c).
- (3) The auditor shall:
 - (i) Perform an audit of the financial statement(s) for the Federal program in accordance with GAGAS;

- (ii) Obtain an understanding of internal control and perform tests of internal control over the Federal program consistent with the requirements of §___.500(c) for a major program;
 - (iii) Perform procedures to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on the Federal program consistent with the requirements of §___.500(d) for a major program; and
 - (iv) Follow up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee, and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding in accordance with the requirements of §___.500(e).
- (4) The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:
- (i) An opinion (or disclaimer of opinion) as to whether the financial statement(s) of the Federal program is presented fairly in all material respects in conformity with the stated accounting policies;
 - (ii) A report on internal control related to the Federal program, which shall describe the scope of testing of internal control and the results of the tests;
 - (iii) A report on compliance which includes an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on the Federal program; and
 - (iv) A schedule of findings and questioned costs for the Federal program that includes a summary of the auditor's results relative to the Federal program in a format consistent with §___.505(d)(1) and findings and questioned costs consistent with the requirements of §___.505(d)(3).

(c) *Report submission for program-specific audits.* (1) The audit shall be completed and the reporting required by paragraph (c)(2) or (c)(3) of this section submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the Federal agency that provided the funding or a different period is specified in a program-specific audit guide. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the required reporting shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period, unless a different period is specified in a program-specific audit guide.) Unless restricted by law or regulation, the auditee shall make report copies available for public inspection.

- (2) When a program-specific audit guide is available, the auditee shall submit to the Federal clearinghouse designated by OMB the data

collection form prepared in accordance with § __.320(b), as applicable to a program-specific audit, and the reporting required by the program-specific audit guide to be retained as an archival copy. Also, the auditee shall submit to the Federal awarding agency or pass-through entity the reporting required by the program-specific audit guide.

- (3) When a program-specific audit guide is not available, the reporting package for a program-specific audit shall consist of the financial statement(s) of the Federal program, a summary schedule of prior audit findings, and a corrective action plan as described in paragraph (b)(2) of this section, and the auditor's report(s) described in paragraph (b)(4) of this section. The data collection form prepared in accordance with § __.320(b), as applicable to a program-specific audit, and one copy of this reporting package shall be submitted to the Federal clearinghouse designated by OMB to be retained as an archival copy. Also, when the schedule of findings and questioned costs disclosed audit findings or the summary schedule of prior audit findings reported the status of any audit findings, the auditee shall submit one copy of the reporting package to the Federal clearinghouse on behalf of the Federal awarding agency, or directly to the pass-through entity in the case of a subrecipient. Instead of submitting the reporting package to the pass-through entity, when a subrecipient is not required to submit a reporting package to the pass-through entity, the subrecipient shall provide written notification to the pass-through entity, consistent with the requirements of § __.320(e)(2). A subrecipient may submit a copy of the reporting package to the pass-through entity to comply with this notification requirement.

(d) *Other sections of this part may apply.* Program-specific audits are subject to § __.100 through § __.215(b), § __.220 through § __.230, § __.300 through § __.305, § __.315, § __.320(f) through § __.320(j), § __.400 through § __.405, § __.510 through § __.515, and other referenced provisions of this part unless contrary to the provisions of this section, a program-specific audit guide, or program laws and regulations.

Subpart C—Auditees

§ __.300 Auditee responsibilities.

The auditee shall:

- (a) Identify, in its accounts, all Federal awards received and expended and the Federal programs under which they were received. Federal program and award identification shall include, as applicable, the CFDA title and number, award number and year, name of the Federal agency, and name of the pass-through entity.
- (b) Maintain internal control over Federal programs that provides reasonable assurance that the auditee is managing Federal awards in compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a material effect on each of its Federal programs.
- (c) Comply with laws, regulations, and the provisions of contracts or grant agreements related to each of its Federal programs.

- (d) Prepare appropriate financial statements, including the schedule of expenditures of Federal awards in accordance with § __.310.
- (e) Ensure that the audits required by this part are properly performed and submitted when due. When extensions to the report submission due date required by § __.320(a) are granted by the cognizant or oversight agency for audit, promptly notify the Federal clearinghouse designated by OMB and each pass-through entity providing Federal awards of the extension.
- (f) Follow up and take corrective action on audit findings, including preparation of a summary schedule of prior audit findings and a corrective action plan in accordance with § __.315(b) and § __.315(c), respectively.

§ __.305 Auditor selection.

(a) *Auditor procurement.* In procuring audit services, auditees shall follow the procurement standards prescribed by the Grants Management Common Rule (hereinafter referred to as the "A-102 Common Rule") published March 11, 1988 and amended April 19, 1995 [insert appropriate CFR citation], Circular A-110, "Uniform Administrative Requirements for Grants and Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations," or the FAR (48 CFR part 42), as applicable (OMB Circulars are available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503). Whenever possible, auditees shall make positive efforts to utilize small businesses, minority-owned firms, and women's business enterprises, in procuring audit services as stated in the A-102 Common Rule, OMB Circular A-110, or the FAR (48 CFR part 42), as applicable. In requesting proposals for audit services, the objectives and scope of the audit should be made clear. Factors to be considered in evaluating each proposal for audit services include the responsiveness to the request for proposal, relevant experience, availability of staff with professional qualifications and technical abilities, the results of external quality control reviews, and price.

(b) *Restriction on auditor preparing indirect cost proposals.* An auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the audit required by this part when the indirect costs recovered by the auditee during the prior year exceeded \$1 million. This restriction applies to the base year used in the preparation of the indirect cost proposal or cost allocation plan and any subsequent years in which the resulting indirect cost agreement or cost allocation plan is used to recover costs. To minimize any disruption in existing contracts for audit services, this paragraph applies to audits of fiscal years beginning after June 30, 1998.

(c) *Use of Federal auditors.* Federal auditors may perform all or part of the work required under this part if they comply fully with the requirements of this part.

§ __.310 Financial statements.

(a) *Financial statements.* The auditee shall prepare financial statements that reflect its financial position, results of operations or changes in net assets, and, where appropriate, cash flows for the fiscal year audited. The financial statements shall be for the same organizational unit and fiscal year that is chosen to meet the requirements of this part. However, organization-wide financial

statements may also include departments, agencies, and other organizational units that have separate audits in accordance with §___.500(a) and prepare separate financial statements.

(b) *Schedule of expenditures of Federal awards.* The auditee shall also prepare a schedule of expenditures of Federal awards for the period covered by the auditee's financial statements. While not required, the auditee may choose to provide information requested by Federal awarding agencies and pass-through entities to make the schedule easier to use. For example, when a Federal program has multiple award years, the auditee may list the amount of Federal awards expended for each award year separately. At a minimum, the schedule shall:

- (1) List individual Federal programs by Federal agency. For Federal programs included in a cluster of programs, list individual Federal programs within a cluster of programs. For R&D, total Federal awards expended shall be shown either by individual award or by Federal agency and major subdivision within the Federal agency. For example, the National Institutes of Health is a major subdivision in the Department of Health and Human Services.
- (2) For Federal awards received as a subrecipient, the name of the pass-through entity and identifying number assigned by the pass-through entity shall be included.
- (3) Provide total Federal awards expended for each individual Federal program and the CFDA number or other identifying number when the CFDA information is not available.
- (4) Include notes that describe the significant accounting policies used in preparing the schedule.
- (5) To the extent practical, pass-through entities should identify in the schedule the total amount provided to subrecipients from each Federal program.
- (6) Include, in either the schedule or a note to the schedule, the value of the Federal awards expended in the form of non-cash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end. While not required, it is preferable to present this information in the schedule.

§___.315 Audit findings follow-up.

(a) *General.* The auditee is responsible for follow-up and corrective action on all audit findings. As part of this responsibility, the auditee shall prepare a summary schedule of prior audit findings. The auditee shall also prepare a corrective action plan for current year audit findings. The summary schedule of prior audit findings and the corrective action plan shall include the reference numbers the auditor assigns to audit findings under §___.510(c). Since the summary schedule may include audit findings from multiple years, it shall include the fiscal year in which the finding initially occurred.

(b) *Summary schedule of prior audit findings.* The summary schedule of prior audit findings shall report the status of all audit findings included in the prior audit's schedule of findings and questioned costs relative to Federal awards. The summary schedule shall also include audit findings reported in the prior audit's summary schedule of prior audit findings except audit findings listed as corrected in accordance with paragraph (b)(1) of this section, or no longer valid or not warranting further action in accordance with paragraph (b)(4) of this section.

- (1) When audit findings were fully corrected, the summary schedule need only list the audit findings and state that corrective action was taken.
 - (2) When audit findings were not corrected or were only partially corrected, the summary schedule shall describe the planned corrective action as well as any partial corrective action taken.
 - (3) When corrective action taken is significantly different from corrective action previously reported in a corrective action plan or in the Federal agency's or pass-through entity's management decision, the summary schedule shall provide an explanation.
 - (4) When the auditee believes the audit findings are no longer valid or do not warrant further action, the reasons for this position shall be described in the summary schedule. A valid reason for considering an audit finding as not warranting further action is that all of the following have occurred:
 - (i) Two years have passed since the audit report in which the finding occurred was submitted to the Federal clearinghouse;
 - (ii) The Federal agency or pass-through entity is not currently following up with the auditee on the audit finding; and
 - (iii) A management decision was not issued.
- (c) *Corrective action plan.* At the completion of the audit, the auditee shall prepare a corrective action plan to address each audit finding included in the current year auditor's reports. The corrective action plan shall provide the name(s) of the contact person(s) responsible for corrective action, the corrective action planned, and the anticipated completion date. If the auditee does not agree with the audit findings or believes corrective action is not required, then the corrective action plan shall include an explanation and specific reasons.

§__320 Report submission.

(a) *General.* The audit shall be completed and the data collection form described in paragraph (b) of this section and reporting package described in paragraph (c) of this section shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or nine months after the end of the audit period, unless a longer period is agreed to in advance by the cognizant or oversight agency for audit. (However, for fiscal years beginning on or before June 30, 1998, the audit shall be completed and the data collection form and reporting package shall be submitted within the earlier of 30 days after receipt of the auditor's report(s), or 13 months after the end of the audit period.) Unless restricted by law or regulation, the auditee shall make copies available for public inspection.

(b) *Data Collection.* (1) The auditee shall submit a data collection form which states whether the audit was completed in accordance with this part and provides information about the auditee, its Federal programs, and the results of the audit. The form shall be approved by OMB, available from the Federal clearinghouse designated by OMB, and include data elements similar to those presented in this paragraph. A senior level representative of the auditee (e.g., State controller, director of finance, chief executive officer, or chief financial officer) shall sign a statement to be included as part of the form certifying that: the auditee complied with the requirements of this part, the form was prepared in accordance with this part (and the instructions accompanying the form), and the information included in the form, in its entirety, are accurate and complete.

- (2) The data collection form shall include the following data elements:
- (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses.
 - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee.
 - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses.
 - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion).
 - (vi) A list of the Federal awarding agencies which will receive a copy of the reporting package pursuant to §___.320(d)(2).
 - (vii) A yes or no statement as to whether the auditee qualified as a low-risk auditee under §___.530.
 - (viii) The dollar threshold used to distinguish between Type A and Type B programs as defined in §___.520(b).
 - (ix) The *Catalog of Federal Domestic Assistance* (CFDA) number for each Federal program, as applicable.
 - (x) The name of each Federal program and identification of each major program. Individual programs within a cluster of programs should be listed in the same level of detail as they are listed in the schedule of expenditures of Federal awards.
 - (xi) The amount of expenditures in the schedule of expenditures of Federal awards associated with each Federal program.
 - (xii) For each Federal program, a yes or no statement as to whether there are audit findings in each of the following types of compliance requirements and the total amount of any questioned costs:
 - (A) Activities allowed or unallowed.
 - (B) Allowable costs/cost principles.
 - (C) Cash management.
 - (D) Davis-Bacon Act.
 - (E) Eligibility.
 - (F) Equipment and real property management.
 - (G) Matching, level of effort, earmarking.
 - (H) Period of availability of Federal funds.
 - (I) Procurement and suspension and debarment.
 - (J) Program income.
 - (K) Real property acquisition and relocation assistance.

- (L) Reporting.
 - (M) Subrecipient monitoring.
 - (N) Special tests and provisions.
- (xiii) Auditee Name, Employer Identification Number(s), Name and Title of Certifying Official, Telephone Number, Signature, and Date.
- (xiv) Auditor Name, Name and Title of Contact Person, Auditor Address, Auditor Telephone Number, Signature, and Date.
- (xv) Whether the auditee has either a cognizant or oversight agency for audit.
- (xvi) The name of the cognizant or oversight agency for audit determined in accordance with §__.400(a) and §__.400(b), respectively.
- (3) Using the information included in the reporting package described in paragraph (c) of this section, the auditor shall complete the applicable sections of the form. The auditor shall sign a statement to be included as part of the data collection form that indicates, at a minimum, the source of the information included in the form, the auditor's responsibility for the information, that the form is not a substitute for the reporting package described in paragraph (c) of this section, and that the content of the form is limited to the data elements prescribed by OMB.
- (c) *Reporting package.* The reporting package shall include the:
- (1) Financial statements and schedule of expenditures of Federal awards discussed in §__.310(a) and §__.310(b), respectively;
 - (2) Summary schedule of prior audit findings discussed in §__.315(b);
 - (3) Auditor's report(s) discussed in §__.505; and
 - (4) Corrective action plan discussed in §__.315(c).
- (d) *Submission to clearinghouse.* All auditees shall submit to the Federal clearinghouse designated by OMB the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section for:
- (1) The Federal clearinghouse to retain as an archival copy; and
 - (2) Each Federal awarding agency when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the Federal awarding agency provided directly or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the Federal awarding agency provided directly.
- (e) *Additional submission by subrecipients.* (1) In addition to the requirements discussed in paragraph (d) of this section, auditees that are also subrecipients shall submit to each pass-through entity one copy of the reporting package described in paragraph (c) of this section for each pass-through entity when the schedule of findings and questioned costs disclosed audit findings relating to Federal awards that the pass-through entity provided or the summary schedule of prior audit findings reported the status of any audit findings relating to Federal awards that the pass-through entity provided.

(2) Instead of submitting the reporting package to a pass-through entity, when a subrecipient is not required to submit a reporting package to a pass-through entity pursuant to paragraph (e)(1) of this section, the subrecipient shall provide written notification to the pass-through entity that: an audit of the subrecipient was conducted in accordance with this part (including the period covered by the audit and the name, amount, and CFDA number of the Federal award(s) provided by the pass-through entity); the schedule of findings and questioned costs disclosed no audit findings relating to the Federal award(s) that the pass-through entity provided; and, the summary schedule of prior audit findings did not report on the status of any audit findings relating to the Federal award(s) that the pass-through entity provided. A subrecipient may submit a copy of the reporting package described in paragraph (c) of this section to a pass-through entity to comply with this notification requirement.

(f) *Requests for report copies.* In response to requests by a Federal agency or pass-through entity, auditees shall submit the appropriate copies of the reporting package described in paragraph (c) of this section and, if requested, a copy of any management letters issued by the auditor.

(g) *Report retention requirements.* Auditees shall keep one copy of the data collection form described in paragraph (b) of this section and one copy of the reporting package described in paragraph (c) of this section on file for three years from the date of submission to the Federal clearinghouse designated by OMB. Pass-through entities shall keep subrecipients' submissions on file for three years from date of receipt.

(h) *Clearinghouse responsibilities.* The Federal clearinghouse designated by OMB shall distribute the reporting packages received in accordance with paragraph (d)(2) of this section and § __.235(c)(3) to applicable Federal awarding agencies, maintain a data base of completed audits, provide appropriate information to Federal agencies, and follow up with known auditees which have not submitted the required data collection forms and reporting packages.

(i) *Clearinghouse address.* The address of the Federal clearinghouse currently designated by OMB is Federal Audit Clearinghouse, Bureau of the Census, 1201 E. 10th Street, Jeffersonville, IN 47132.

(j) *Electronic filing.* Nothing in this part shall preclude electronic submissions to the Federal clearinghouse in such manner as may be approved by OMB. With OMB approval, the Federal clearinghouse may pilot test methods of electronic submissions.

Subpart D—Federal Agencies and Pass-Through Entities

§ __.400 Responsibilities.

(a) *Cognizant agency for audit responsibilities.* Recipients expending more than \$25 million a year in Federal awards shall have a cognizant agency for audit. The designated cognizant agency for audit shall be the Federal awarding agency that provides the predominant amount of direct funding to a recipient unless OMB makes a specific cognizant agency for audit assignment. To provide for continuity of cognizance, the determination of the predominant amount of direct funding shall be based upon direct Federal awards expended in the recipient's fiscal years ending in 1995, 2000, 2005, and every fifth year thereafter. For example, audit cognizance for periods ending in 1997 through 2000

will be determined based on Federal awards expended in 1995. (However, for States and local governments that expend more than \$25 million a year in Federal awards and have previously assigned cognizant agencies for audit, the requirements of this paragraph are not effective until fiscal years beginning after June 30, 2000.) Notwithstanding the manner in which audit cognizance is determined, a Federal awarding agency with cognizance for an auditee may reassign cognizance to another Federal awarding agency which provides substantial direct funding and agrees to be the cognizant agency for audit. Within 30 days after any reassignment, both the old and the new cognizant agency for audit shall notify the auditee, and, if known, the auditor of the reassignment. The cognizant agency for audit shall:

- (1) Provide technical audit advice and liaison to auditees and auditors.
- (2) Consider auditee requests for extensions to the report submission due date required by §___.320(a). The cognizant agency for audit may grant extensions for good cause.
- (3) Obtain or conduct quality control reviews of selected audits made by non-Federal auditors, and provide the results, when appropriate, to other interested organizations.
- (4) Promptly inform other affected Federal agencies and appropriate Federal law enforcement officials of any direct reporting by the auditee or its auditor of irregularities or illegal acts, as required by GAGAS or laws and regulations.
- (5) Advise the auditor and, where appropriate, the auditee of any deficiencies found in the audits when the deficiencies require corrective action by the auditor. When advised of deficiencies, the auditee shall work with the auditor to take corrective action. If corrective action is not taken, the cognizant agency for audit shall notify the auditor, the auditee, and applicable Federal awarding agencies and pass-through entities of the facts and make recommendations for follow-up action. Major inadequacies or repetitive substandard performance by auditors shall be referred to appropriate State licensing agencies and professional bodies for disciplinary action.
- (6) Coordinate, to the extent practical, audits or reviews made by or for Federal agencies that are in addition to the audits made pursuant to this part, so that the additional audits or reviews build upon audits performed in accordance with this part.
- (7) Coordinate a management decision for audit findings that affect the Federal programs of more than one agency.
- (8) Coordinate the audit work and reporting responsibilities among auditors to achieve the most cost-effective audit.
- (9) For biennial audits permitted under §___.220, consider auditee requests to qualify as a low-risk auditee under §___.530(a).

(b) *Oversight agency for audit responsibilities.* An auditee which does not have a designated cognizant agency for audit will be under the general oversight of the Federal agency determined in accordance with §___.105. The oversight agency for audit:

- (1) Shall provide technical advice to auditees and auditors as requested.

- (2) May assume all or some of the responsibilities normally performed by a cognizant agency for audit.
- (c) *Federal awarding agency responsibilities.* The Federal awarding agency shall perform the following for the Federal awards it makes:
- (1) Identify Federal awards made by informing each recipient of the CFDA title and number, award name and number, award year, and if the award is for R&D. When some of this information is not available, the Federal agency shall provide information necessary to clearly describe the Federal award.
 - (2) Advise recipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements.
 - (3) Ensure that audits are completed and reports are received in a timely manner and in accordance with the requirements of this part.
 - (4) Provide technical advice and counsel to auditees and auditors as requested.
 - (5) Issue a management decision on audit findings within six months after receipt of the audit report and ensure that the recipient takes appropriate and timely corrective action.
 - (6) Assign a person responsible for providing annual updates of the compliance supplement to OMB.
- (d) *Pass-through entity responsibilities.* A pass-through entity shall perform the following for the Federal awards it makes:
- (1) Identify Federal awards made by informing each subrecipient of CFDA title and number, award name and number, award year, if the award is R&D, and name of Federal agency. When some of this information is not available, the pass-through entity shall provide the best information available to describe the Federal award.
 - (2) Advise subrecipients of requirements imposed on them by Federal laws, regulations, and the provisions of contracts or grant agreements as well as any supplemental requirements imposed by the pass-through entity.
 - (3) Monitor the activities of subrecipients as necessary to ensure that Federal awards are used for authorized purposes in compliance with laws, regulations, and the provisions of contracts or grant agreements and that performance goals are achieved.
 - (4) Ensure that subrecipients expending \$300,000 or more in Federal awards during the subrecipient's fiscal year have met the audit requirements of this part for that fiscal year.
 - (5) Issue a management decision on audit findings within six months after receipt of the subrecipient's audit report and ensure that the subrecipient takes appropriate and timely corrective action.
 - (6) Consider whether subrecipient audits necessitate adjustment of the pass-through entity's own records.
 - (7) Require each subrecipient to permit the pass-through entity and auditors to have access to the records and financial statements as necessary for the pass-through entity to comply with this part.

§__405 Management decision.

- (a) *General.* The management decision shall clearly state whether or not the audit finding is sustained, the reasons for the decision, and the expected auditee

action to repay disallowed costs, make financial adjustments, or take other action. If the auditee has not completed corrective action, a timetable for follow-up should be given. Prior to issuing the management decision, the Federal agency or pass-through entity may request additional information or documentation from the auditee, including a request for auditor assurance related to the documentation, as a way of mitigating disallowed costs. The management decision should describe any appeal process available to the auditee.

(b) *Federal agency.* As provided in §___.400(a)(7), the cognizant agency for audit shall be responsible for coordinating a management decision for audit findings that affect the programs of more than one Federal agency. As provided in §___.400(c)(5), a Federal awarding agency is responsible for issuing a management decision for findings that relate to Federal awards it makes to recipients. Alternate arrangements may be made on a case-by-case basis by agreement among the Federal agencies concerned.

(c) *Pass-through entity.* As provided in §___.400(d)(5), the pass-through entity shall be responsible for making the management decision for audit findings that relate to Federal awards it makes to subrecipients.

(d) *Time requirements.* The entity responsible for making the management decision shall do so within six months of receipt of the audit report. Corrective action should be initiated within six months after receipt of the audit report and proceed as rapidly as possible.

(e) *Reference numbers.* Management decisions shall include the reference numbers the auditor assigned to each audit finding in accordance with §___.510(c).

Subpart E—Auditors

§___.500 Scope of audit.

(a) *General.* The audit shall be conducted in accordance with GAGAS. The audit shall cover the entire operations of the auditee; or, at the option of the auditee, such audit shall include a series of audits that cover departments, agencies, and other organizational units which expended or otherwise administered Federal awards during such fiscal year, provided that each such audit shall encompass the financial statements and schedule of expenditures of Federal awards for each such department, agency, and other organizational unit, which shall be considered to be a non-Federal entity. The financial statements and schedule of expenditures of Federal awards shall be for the same fiscal year.

(b) *Financial statements.* The auditor shall determine whether the financial statements of the auditee are presented fairly in all material respects in conformity with generally accepted accounting principles. The auditor shall also determine whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the auditee's financial statements taken as a whole.

(c) *Internal control.* (1) In addition to the requirements of GAGAS, the auditor shall perform procedures to obtain an understanding of internal control over Federal programs sufficient to plan the audit to support a low assessed level of control risk for major programs.

(2) Except as provided in paragraph (c)(3) of this section, the auditor shall:

- (i) Plan the testing of internal control over major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program; and
 - (ii) Perform testing of internal control as planned in paragraph (c)(2)(i) of this section.
- (3) When internal control over some or all of the compliance requirements for a major program are likely to be ineffective in preventing or detecting noncompliance, the planning and performing of testing described in paragraph (c)(2) of this section are not required for those compliance requirements. However, the auditor shall report a reportable condition (including whether any such condition is a material weakness) in accordance with §___.510, assess the related control risk at the maximum, and consider whether additional compliance tests are required because of ineffective internal control.
- (d) *Compliance.* (1) In addition to the requirements of GAGAS, the auditor shall determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each of its major programs.
- (2) The principal compliance requirements applicable to most Federal programs and the compliance requirements of the largest Federal programs are included in the compliance supplement.
 - (3) For the compliance requirements related to Federal programs contained in the compliance supplement, an audit of these compliance requirements will meet the requirements of this part. Where there have been changes to the compliance requirements and the changes are not reflected in the compliance supplement, the auditor shall determine the current compliance requirements and modify the audit procedures accordingly. For those Federal programs not covered in the compliance supplement, the auditor should use the types of compliance requirements contained in the compliance supplement as guidance for identifying the types of compliance requirements to test, and determine the requirements governing the Federal program by reviewing the provisions of contracts and grant agreements and the laws and regulations referred to in such contracts and grant agreements.
 - (4) The compliance testing shall include tests of transactions and such other auditing procedures necessary to provide the auditor sufficient evidence to support an opinion on compliance.
- (e) *Audit follow-up.* The auditor shall follow-up on prior audit findings, perform procedures to assess the reasonableness of the summary schedule of prior audit findings prepared by the auditee in accordance with §___.315(b), and report, as a current year audit finding, when the auditor concludes that the summary schedule of prior audit findings materially misrepresents the status of any prior audit finding. The auditor shall perform audit follow-up procedures regardless of whether a prior audit finding relates to a major program in the current year.
- (f) *Data Collection Form.* As required in §___.320(b)(3), the auditor shall complete and sign specified sections of the data collection form.

§__505 Audit reporting.

The auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in this section. The auditor's report(s) shall state that the audit was conducted in accordance with this part and include the following:

- (a) An opinion (or disclaimer of opinion) as to whether the financial statements are presented fairly in all material respects in conformity with generally accepted accounting principles and an opinion (or disclaimer of opinion) as to whether the schedule of expenditures of Federal awards is presented fairly in all material respects in relation to the financial statements taken as a whole.
- (b) A report on internal control related to the financial statements and major programs. This report shall describe the scope of testing of internal control and the results of the tests, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.
- (c) A report on compliance with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a material effect on the financial statements. This report shall also include an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements which could have a direct and material effect on each major program, and, where applicable, refer to the separate schedule of findings and questioned costs described in paragraph (d) of this section.
- (d) A schedule of findings and questioned costs which shall include the following three components:
 - (1) A summary of the auditor's results which shall include:
 - (i) The type of report the auditor issued on the financial statements of the auditee (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
 - (ii) Where applicable, a statement that reportable conditions in internal control were disclosed by the audit of the financial statements and whether any such conditions were material weaknesses;
 - (iii) A statement as to whether the audit disclosed any noncompliance which is material to the financial statements of the auditee;
 - (iv) Where applicable, a statement that reportable conditions in internal control over major programs were disclosed by the audit and whether any such conditions were material weaknesses;
 - (v) The type of report the auditor issued on compliance for major programs (i.e., unqualified opinion, qualified opinion, adverse opinion, or disclaimer of opinion);
 - (vi) A statement as to whether the audit disclosed any audit findings which the auditor is required to report under §__510(a);
 - (vii) An identification of major programs;

- (viii) The dollar threshold used to distinguish between Type A and Type-B programs, as described in §___.520(b); and
 - (ix) A statement as to whether the auditee qualified as a low-risk auditee under §___.530.
- (2) Findings relating to the financial statements which are required to be reported in accordance with GAGAS.
 - (3) Findings and questioned costs for Federal awards which shall include audit findings as defined in §___.510(a).
 - (i) Audit findings (e.g., internal control findings, compliance findings, questioned costs, or fraud) which relate to the same issue should be presented as a single audit finding. Where practical, audit findings should be organized by Federal agency or pass-through entity.
 - (ii) Audit findings which relate to both the financial statements and Federal awards, as reported under paragraphs (d)(2) and (d)(3) of this section, respectively, should be reported in both sections of the schedule. However, the reporting in one section of the schedule may be in summary form with a reference to a detailed reporting in the other section of the schedule.

§___.510 Audit findings.

(a) *Audit findings reported.* The auditor shall report the following as audit findings in a schedule of findings and questioned costs:

- (1) Reportable conditions in internal control over major programs. The auditor's determination of whether a deficiency in internal control is a reportable condition 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 compliance supplement. The auditor shall identify reportable conditions which are individually or cumulatively material weaknesses.
- (2) Material noncompliance with the provisions of laws, regulations, contracts, or grant agreements related to a major program. The auditor's determination of whether a noncompliance with the provisions of laws, regulations, contracts, or grant agreements is material 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 compliance supplement.
- (3) Known questioned costs which are greater than \$10,000 for a type of compliance requirement for a major program. Known questioned costs are those specifically identified by the auditor. In evaluating the effect of questioned costs on the opinion on compliance, the auditor considers the best estimate of total costs questioned (likely questioned costs), not just the questioned costs specifically identified (known questioned costs). The auditor shall also report known questioned costs when likely questioned costs are greater than \$10,000 for a type of compliance requirement for a major program. In reporting questioned costs, the auditor shall include information to provide proper perspective for judging the prevalence and consequences of the questioned costs.

- (4) Known questioned costs which are greater than \$10,000 for a Federal program which is not audited as a major program. Except for audit follow-up, the auditor is not required under this part to perform audit procedures for such a Federal program; therefore, the auditor will normally not find questioned costs for a program which is not audited as a major program. However, if the auditor does become aware of questioned costs for a Federal program which is not audited as a major program (e.g., as part of audit follow-up or other audit procedures) and the known questioned costs are greater than \$10,000, then the auditor shall report this as an audit finding.
- (5) The circumstances concerning why the auditor's report on compliance for major programs is other than an unqualified opinion, unless such circumstances are otherwise reported as audit findings in the schedule of findings and questioned costs for Federal awards.
- (6) Known fraud affecting a Federal award, unless such fraud is otherwise reported as an audit finding in the schedule of findings and questioned costs for Federal awards. This paragraph does not require the auditor to make an additional reporting when the auditor confirms that the fraud was reported outside of the auditor's reports under the direct reporting requirements of GAGAS.
- (7) Instances where the results of audit follow-up procedures disclosed that the summary schedule of prior audit findings prepared by the auditee in accordance with §___.315(b) materially misrepresents the status of any prior audit finding.

(b) *Audit finding detail.* Audit findings shall be presented in sufficient detail for the auditee to prepare a corrective action plan and take corrective action and for Federal agencies and pass-through entities to arrive at a management decision. The following specific information shall be included, as applicable, in audit findings:

- (1) Federal program and specific Federal award identification including the CFDA title and number, Federal award number and year, name of Federal agency, and name of the applicable pass-through entity. When information, such as the CFDA title and number or Federal award number, is not available, the auditor shall provide the best information available to describe the Federal award.
- (2) The criteria or specific requirement upon which the audit finding is based, including statutory, regulatory, or other citation.
- (3) The condition found, including facts that support the deficiency identified in the audit finding.
- (4) Identification of questioned costs and how they were computed.
- (5) Information to provide proper perspective for judging the prevalence and consequences of the audit findings, such as whether the audit findings represent an isolated instance or a systemic problem. Where appropriate, instances identified shall be related to the universe and the number of cases examined and be quantified in terms of dollar value.
- (6) The possible asserted effect to provide sufficient information to the auditee and Federal agency, or pass-through entity in the case of a subrecipient, to permit them to determine the cause and effect to facilitate prompt and proper corrective action.

- (7) Recommendations to prevent future occurrences of the deficiency identified in the audit finding.
 - (8) Views of responsible officials of the auditee when there is disagreement with the audit findings, to the extent practical.
- (c) *Reference numbers.* Each audit finding in the schedule of findings and questioned costs shall include a reference number to allow for easy referencing of the audit findings during follow-up.

§__515 Audit working papers.

(a) *Retention of working papers.* The auditor shall retain working papers and reports for a minimum of three years after the date of issuance of the auditor's report(s) to the auditee, unless the auditor is notified in writing by the cognizant agency for audit, oversight agency for audit, or pass-through entity to extend the retention period. When the auditor is aware that the Federal awarding agency, pass-through entity, or auditee is contesting an audit finding, the auditor shall contact the parties contesting the audit finding for guidance prior to destruction of the working papers and reports.

(b) *Access to working papers.* Audit working papers shall be made available upon request to the cognizant or oversight agency for audit or its designee, a Federal agency providing direct or indirect funding, or GAO at the completion of the audit, as part of a quality review, to resolve audit findings, or to carry out oversight responsibilities consistent with the purposes of this part. Access to working papers includes the right of Federal agencies to obtain copies of working papers, as is reasonable and necessary.

§__520 Major program determination.

(a) *General.* The auditor shall use a risk-based approach to determine which Federal programs are major programs. This risk-based approach shall include consideration of: Current and prior audit experience, oversight by Federal agencies and pass-through entities, and the inherent risk of the Federal program. The process in paragraphs (b) through (i) of this section shall be followed.

(b) *Step 1.* (1) The auditor shall identify the larger Federal programs, which shall be labeled Type A programs. Type A programs are defined as Federal programs with Federal awards expended during the audit period exceeding the larger of:

- (i) \$300,000 or three percent (.03) of total Federal awards expended in the case of an auditee for which total Federal awards expended equal or exceed \$300,000 but are less than or equal to \$100 million.
 - (ii) \$3 million or three-tenths of one percent (.003) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$100 million but are less than or equal to \$10 billion.
 - (iii) \$30 million or 15 hundredths of one percent (.0015) of total Federal awards expended in the case of an auditee for which total Federal awards expended exceed \$10 billion.
- (2) Federal programs not labeled Type A under paragraph (b)(1) of this section shall be labeled Type B programs.
 - (3) 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.

- (4) For biennial audits permitted under § __.220, the determination of Type A and Type B programs shall be based upon the Federal awards expended during the two-year period.

(c) *Step 2.* (1) The auditor shall identify Type A programs which are low-risk. For a Type A program to be considered low-risk, it shall have been audited as a major program in at least one of the two most recent audit periods (in the most recent audit period in the case of a biennial audit), and, in the most recent audit period, it shall have had no audit findings under § __.510(a). However, the auditor may use judgment and consider that audit findings from questioned costs under § __.510(a)(3) and § __.510(a)(4), fraud under § __.510(a)(6), and audit follow-up for the summary schedule of prior audit findings under § __.510(a)(7) do not preclude the Type A program from being low-risk. The auditor shall consider: the criteria in § __.525(c), § __.525(d)(1), § __.525(d)(2), and § __.525(d)(3); the results of audit follow-up; whether any changes in personnel or systems affecting a Type A program have significantly increased risk; and apply professional judgment in determining whether a Type A program is low-risk.

- (2) Notwithstanding paragraph (c)(1) of this section, OMB may approve a Federal awarding agency's request that a Type A program at certain recipients may not be considered low-risk. For example, it may be necessary for a large Type A program to be audited as major each year at particular recipients to allow the Federal agency to comply with the Government Management Reform Act of 1994 (31 U.S.C. 3515). The Federal agency shall notify the recipient and, if known, the auditor at least 180 days prior to the end of the fiscal year to be audited of OMB's approval.

(d) *Step 3.* (1) The auditor shall identify Type B programs which are high-risk using professional judgment and the criteria in § __.525. However, should the auditor select Option 2 under Step 4 (paragraph (e)(2)(i)(B) of this section), the auditor is not required to identify more high-risk Type B programs than the number of low-risk Type A programs. Except for known reportable conditions in internal control or compliance problems as discussed in § __.525(b)(1), § __.525(b)(2), and § __.525(c)(1), a single criteria in § __.525 would seldom cause a Type B program to be considered high-risk.

- (2) The auditor is not expected to perform risk assessments on relatively small Federal programs. Therefore, the auditor is only required to perform risk assessments on Type B programs that exceed the larger of:
- (i) \$100,000 or three-tenths of one percent (.003) of total Federal awards expended when the auditee has less than or equal to \$100 million in total Federal awards expended.
 - (ii) \$300,000 or three-hundredths of one percent (.0003) of total Federal awards expended when the auditee has more than \$100 million in total Federal awards expended.

(e) *Step 4.* At a minimum, the auditor shall audit all of the following as major programs:

- (1) All Type A programs, except the auditor may exclude any Type A programs identified as low-risk under Step 2 (paragraph (c)(1) of this section).
 - (2)(i) High-risk Type B programs as identified under either of the following two options:
 - (A) *Option 1.* At least one half of the Type B programs identified as high-risk under Step 3 (paragraph (d) of this section), except this paragraph (e)(2)(i)(A) does not require the auditor to audit more high-risk Type B programs than the number of low-risk Type A programs identified as low-risk under Step 2.
 - (B) *Option 2.* One high-risk Type B program for each Type A program identified as low-risk under Step 2.
 - (ii) When identifying which high-risk Type B programs to audit as major under either Option 1 or 2 in paragraph (e)(2)(i)(A) or (B) of this section, the auditor is encouraged to use an approach which provides an opportunity for different high-risk Type B programs to be audited as major over a period of time.
 - (3) Such additional programs as may be necessary to comply with the percentage of coverage rule discussed in paragraph (f) of this section. This paragraph (e)(3) may require the auditor to audit more programs as major than the number of Type A programs.
- (f) *Percentage of coverage rule.* The auditor shall audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 50 percent of total Federal awards expended. If the auditee meets the criteria in §___530 for a low-risk auditee, the auditor need only audit as major programs Federal programs with Federal awards expended that, in the aggregate, encompass at least 25 percent of total Federal awards expended.
- (g) *Documentation of risk.* The auditor shall document in the working papers the risk analysis process used in determining major programs.
- (h) *Auditor's judgment.* When the major program determination was performed and documented in accordance with this part, the auditor's judgment in applying the risk-based approach to determine major programs shall be presumed correct. Challenges by Federal agencies and pass-through entities shall only be for clearly improper use of the guidance in this part. However, Federal agencies and pass-through entities may provide auditors guidance about the risk of a particular Federal program and the auditor shall consider this guidance in determining major programs in audits not yet completed.
- (i) *Deviation from use of risk criteria.* For first-year audits, the auditor may elect to determine major programs as all Type A programs plus any Type B programs as necessary to meet the percentage of coverage rule discussed in paragraph (f) of this section. Under this option, the auditor would not be required to perform the procedures discussed in paragraphs (c), (d), and (e) of this section.
- (1) A first-year audit is the first year the entity is audited under this part or the first year of a change of auditors.
 - (2) To ensure that a frequent change of auditors would not preclude audit of high-risk Type B programs, this election for first-year audits may not be used by an auditee more than once in every three years.

§ __.525 Criteria for Federal program risk.

(a) *General.* The auditor's determination should be based on an overall evaluation of the risk of noncompliance occurring which could be material to the Federal program. The auditor shall use auditor judgment and consider criteria, such as described in paragraphs (b), (c), and (d) of this section, to identify risk in Federal programs. Also, as part of the risk analysis, the auditor may wish to discuss a particular Federal program with auditee management and the Federal agency or pass-through entity.

(b) *Current and prior audit experience.* (1) Weaknesses in internal control over Federal programs would indicate higher risk. Consideration should be given to the control environment over Federal programs and such factors as the expectation of management's adherence to applicable laws and regulations and the provisions of contracts and grant agreements and the competence and experience of personnel who administer the Federal programs.

- (i) A Federal program administered under multiple internal control structures may have higher risk. When assessing risk in a large single audit, the auditor shall consider whether weaknesses are isolated in a single operating unit (e.g., one college campus) or pervasive throughout the entity.
 - (ii) When significant parts of a Federal program are passed through to subrecipients, a weak system for monitoring subrecipients would indicate higher risk.
 - (iii) The extent to which computer processing is used to administer Federal programs, as well as the complexity of that processing, should be considered by the auditor in assessing risk. New and recently modified computer systems may also indicate risk.
- (2) Prior audit findings would indicate higher risk, particularly when the situations identified in the audit findings could have a significant impact on a Federal program or have not been corrected.
- (3) Federal programs not recently audited as major programs may be of higher risk than Federal programs recently audited as major programs without audit findings.

(c) *Oversight exercised by Federal agencies and pass-through entities.* (1) Oversight exercised by Federal agencies or pass-through entities could indicate risk. For example, recent monitoring or other reviews performed by an oversight entity which disclosed no significant problems would indicate lower risk. However, monitoring which disclosed significant problems would indicate higher risk.

- (2) Federal agencies, with the concurrence of OMB, may identify Federal programs which are higher risk. OMB plans to provide this identification in the compliance supplement.

(d) *Inherent risk of the Federal program.* (1) The nature of a Federal program may indicate risk. Consideration should be given to the complexity of the program and the extent to which the Federal program contracts for goods and services. For example, Federal programs that disburse funds through third party contracts or have eligibility criteria may be of higher risk. Federal programs primarily involving staff payroll costs may have a high-risk for time and effort reporting, but otherwise be at low-risk.

- (2) The phase of a Federal program in its life cycle at the Federal agency may indicate risk. For example, a new Federal program with new or inter-

im regulations may have higher risk than an established program with time-tested regulations. Also, significant changes in Federal programs, laws, regulations, or the provisions of contracts or grant agreements may increase risk.

- (3) The phase of a Federal program in its life cycle at the auditee may indicate risk. For example, during the first and last years that an auditee participates in a Federal program, the risk may be higher due to start-up or closeout of program activities and staff.
- (4) Type B programs with larger Federal awards expended would be of higher risk than programs with substantially smaller Federal awards expended.

§___.530 Criteria for a low-risk auditee.

An auditee which meets all of the following conditions for each of the preceding two years (or, in the case of biennial audits, preceding two audit periods) shall qualify as a low-risk auditee and be eligible for reduced audit coverage in accordance with §___.520:

- (a) Single audits were performed on an annual basis in accordance with the provisions of this part. A non-Federal entity that has biennial audits does not qualify as a low-risk auditee, unless agreed to in advance by the cognizant or oversight agency for audit.
- (b) The auditor's opinions on the financial statements and the schedule of expenditures of Federal awards were unqualified. However, the cognizant or oversight agency for audit may judge that an opinion qualification does not affect the management of Federal awards and provide a waiver.
- (c) There were no deficiencies in internal control which were identified as material weaknesses under the requirements of GAGAS. However, the cognizant or oversight agency for audit may judge that any identified material weaknesses do not affect the management of Federal awards and provide a waiver.
- (d) None of the Federal programs had audit findings from any of the following in either of the preceding two years (or, in the case of biennial audits, preceding two audit periods) in which they were classified as Type A programs:
 - (1) Internal control deficiencies which were identified as material weaknesses;
 - (2) Noncompliance with the provisions of laws, regulations, contracts, or grant agreements which have a material effect on the Type A program; or
 - (3) Known or likely questioned costs that exceed five percent of the total Federal awards expended for a Type A program during the year.

Appendix A to Part ___—Data Collection Form (Form SF-SAC)

[Insert SF-SAC after finalized]

Appendix B to Part ___—Circular A-133 Compliance Supplement

Note: Provisional OMB Circular A-133 Compliance Supplement is available from the Office of Administration, Publications Office, room 2200, New Executive Office Building, Washington, DC 20503.

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Appendix C

Illustrative Schedules of Expenditures of Federal Awards

Example Entity
Schedule of Expenditures of Federal Awards¹
For the Year Ended June 30, 19X1²

<i>Federal Grantor/Pass-Through Grantor/Program or Cluster Title</i>	<i>Federal CFDA Number³</i>	<i>Pass-Through Entity Identifying Number⁴</i>	<i>Federal Expenditures⁵</i>
U.S. Department of Agriculture:			
Summer Food Service Program for Children—Commodities	10.559		\$ 46,000
<i>Total U.S. Department of Agriculture</i>			\$ 46,000
U.S. Department of Housing and Urban Development:			
Community Development Block Grant—Entitlement Grants (note 2)	14.218		\$1,235,632
Section 8 Rental Voucher Program	14.855		800,534
<i>Total U.S. Department of Housing and Urban Development</i>			\$2,036,166
U.S. Department of Education:			
Impact Aid	84.041		\$ 372,555
Bilingual Education	84.288		28,655
<i>Subtotal Direct Programs</i>			\$ 401,210
Pass-Through Program From:			
State Department of Education—Title I Grants to Local Educational Agencies	84.010	23-8345-7612	\$1,239,398
<i>Total U.S. Department of Education</i>			\$1,640,608
<i>Total Expenditures of Federal Awards</i>			<u>\$3,722,774</u>

The accompanying notes are an integral part of this schedule.

¹ To meet state or other requirements, auditees may decide to include certain nonfederal awards (for example, state awards) in this schedule. If such nonfederal data are presented, they should be segregated and clearly designated as nonfederal. The title of the schedule should also be modified to indicate that nonfederal awards are included.

² Additional guidance on the schedule is provided in chapter 5 which includes a discussion of the identification of federal awards, the general presentation requirements governing the schedule, pass-through awards, noncash awards, and endowment funds. Chapter 5 also includes a discussion of the auditor's responsibility for reporting on the schedule.

³ When the CFDA number is not available, the auditee should indicate that the CFDA number is not available and include in the schedule the program's name and, if available, other identifying number.

⁴ When awards are received as a subrecipient, the identifying number assigned by the pass-through entity should be included in the schedule.

⁵ Circular A-133 requires that the value of federal awards expended in the form of noncash assistance, the amount of insurance in effect during the year, and loans or loan guarantees outstanding at year end be included in either the schedule or a note to the schedule. Although it is not required, Circular A-133 states that it is preferable to present this information in the schedule (versus the notes to the schedule). If the auditee presents noncash assistance in the notes to the schedule, the auditor should be aware that such amounts must still be included in part III of the data collection form.

Example Entity
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 19X1

Note 1. Basis of Presentation⁶

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity and is presented on the [identify basis of accounting]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the [general-purpose or basic] financial statements.

Note 2. Subrecipients⁷

Of the federal expenditures presented in the schedule, Example Entity provided federal awards to subrecipients as follows:

<i>Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Provided to Subrecipients</i>
Community Development Block Grant—Entitlement Grants	14.218	\$423,965

⁶ This note is included to meet the Circular A-133 requirement that the schedule include notes that describe the significant accounting policies used in preparing the schedule.

⁷ Circular A-133 requires the schedule of expenditures of federal awards to include, to the extent practical, an identification of the total amount provided to subrecipients from each federal program. Although this example includes the required subrecipient information in the notes to the schedule, the information may be included on the face of the schedule as a separate column or section, if that is preferred by the auditee.

Example Entity University
Schedule of Expenditures of Federal Awards⁸
For the Year Ended June 30, 19X1⁹

<i>Federal Grantor / Pass-Through Grantor / Program or Cluster Title</i>	<i>Federal CFDA¹⁰ Number</i>	<i>Pass-Through Entity Identifying Number¹¹</i>	<i>Federal Expenditures¹²</i>
<i>Student Financial Aid—Cluster:</i>			
U.S. Department of Education:			
Federal Pell Grant Program	84.063		\$ 8,764,943
Federal Supplemental Educational Opportunity Grant	84.007		974,873
Federal Work-Study Program	84.033		575,417
Federal Perkins Loan Program (note 2)	84.038		<u>1,548,343</u>
<i>Total U.S. Department of Education</i>			<u>\$11,863,576</u>
U.S. Department of Health and Human Services:			
Nursing Student Loans (note 2)	93.364		\$ 823,582
<i>Total U.S. Department of Health and Human Services</i>			<u>\$ 823,582</u>
<i>Total Student Financial Aid</i>			<u>\$12,687,158</u>
<i>Research and Development—Cluster:¹³</i>			
U.S. Department of Defense:			
Department of Army	N.A.		\$ 87,403
Office of Naval Research	N.A.		<u>73,107</u>
Subtotal Direct Programs			<u>\$ 160,510</u>
Pass-Through Programs From:			
XYZ Labs—Effects of Ice on Radar Images	N.A.	4532	<u>\$ 11,987</u>
<i>Total U.S. Department of Defense</i>			<u>\$ 172,497</u>
National Science Foundation:			
National Science Foundation (note 3)	N.A.		\$ 432,111
Pass-Through Programs From:			
ABC University—Atmospheric Effects of Volcano Eruptions	N.A.	Abc97-8	<u>\$ 25,987</u>
<i>Total National Science Foundation</i>			<u>\$ 458,098</u>
U.S. Department of Health and Human Services:			
National Institutes of Health	N.A.		\$ 675,321
Administration on Aging (note 3)	N.A.		<u>234,987</u>
Subtotal Direct Programs			<u>\$ 910,308</u>

⁸ See footnote 1.

⁹ See footnote 2.

¹⁰ See footnote 3.

¹¹ See footnote 4.

¹² See footnote 5.

¹³ For R&D, Circular A-133 requires that total federal awards expended must be shown either by individual award or by federal agency and major subdivision within the federal agency. This example illustrates the federal agency and major subdivision option.

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<i>Federal Grantor / Pass-Through Grantor / Program or Cluster Title</i>	<i>Federal CFDA Number¹⁰</i>	<i>Pass-Through Entity Identifying Number¹¹</i>	<i>Federal Expenditures¹²</i>
Pass-Through Programs From:			
ABC Hospital—Heart Research	N.A.	5489-5	\$ 432,765
State Health Department—Food Safety Research	N.A.	SG673-45	<u>123,987</u>
Subtotal Pass-Through Programs			\$ 556,752
<i>Total U.S. Department of Health and Human Services</i>			\$ 1,467,060
<i>Total Research and Development</i>			\$ 2,097,655
Other Programs:			
U.S. Department of Energy:			
Educational Exchange—University Lectures and Research	82.002		\$ 17,823
<i>Total U.S. Department of Energy</i>			\$ 17,823
U.S. Department of Education:			
TRIO Talent Search	84.044		\$ 308,465
Safe and Drug-Free Schools and Communities	84.184		<u>59,723</u>
Subtotal Direct Programs			\$ 368,188
Pass-Through Programs From:			
State Department of Education—Vocational Education Basic Grant	84.048	874-90-5473	\$ 3,115
State Department of Education— Tech-Prep Education	84.243	25-8594-2167	<u>176,885</u>
Subtotal Pass-Through Programs			\$ 180,000
<i>Total U.S. Department of Education</i>			\$ 548,188
<i>Total Other Programs</i>			\$ 566,011
<i>Total Expenditures of Federal Awards</i>			<u><u>\$15,350,824</u></u>
N.A. = Not Available			

The accompanying notes are an integral part of this schedule.

Example Entity University
Notes to the Schedule of Expenditures of Federal Awards
For the Year Ended June 30, 19X1

Note 1. Basis of Presentation¹⁴

The accompanying schedule of expenditures of federal awards includes the federal grant activity of Example Entity University and is presented on the [*identify basis of accounting*]. The information in this schedule is presented in accordance with the requirements of OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Therefore, some amounts presented in this schedule may differ from amounts presented in, or used in the preparation of, the [*general-purpose or basic*] financial statements.

Note 2. Loans Outstanding¹⁵

Example Entity University had the following loan balances outstanding at June 30, 19X1. These loan balances outstanding are also included in the federal expenditures presented in the schedule.

<i>Cluster / Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Outstanding</i>
Federal Perkins Loan Program	84.038	\$1,268,236
Nursing Student Loans	93.364	\$ 763,127

Note 3. Subrecipients¹⁶

Of the federal expenditures presented in the schedule, Example Entity University provided federal awards to subrecipients as follows:

<i>Program Title</i>	<i>Federal CFDA Number</i>	<i>Amount Provided to Subrecipients</i>
National Science Foundation	N.A.	\$236,403
Administration on Aging	N.A.	\$138,095

¹⁴ See footnote 6.

¹⁵ This note is intended to meet the Circular A-133 requirement that loans or loan guarantees outstanding at year end be included in the schedule.

¹⁶ See footnote 7.

Appendix D

[Revised, June 1999, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

Illustrative Auditor's Reports

D.1. This appendix contains examples of the reports issued under GAAS, *Government Auditing Standards*, and Circular A-133 in various circumstances for a single audit. Also included are examples of the reports issued for a program-specific audit.

D.2. As discussed in chapter 10, reporting on a financial statement audit and on the compliance requirements applicable to each major program involves varying levels of materiality and different forms of reporting. Circular A-133 states that the auditor's report(s) may be in the form of either combined or separate reports and may be organized differently from the manner presented in the circular. In an effort to make the reports understandable and to reduce the number of reports issued, this SOP recommends that the following reports be issued for a single audit (the basic elements of each of the recommended reports are discussed in chapter 10):

- An opinion on the financial statements and on the supplementary schedule of expenditures of federal awards
- A report on compliance and on the internal control over financial reporting based on an audit of financial statements performed in accordance with *Government Auditing Standards*
- A report on compliance with requirements applicable to each major program and on the internal control over compliance in accordance with Circular A-133

D.3. Furthermore, as discussed in chapter 11, this SOP recommends that the following reports be issued for a program-specific audit (see paragraph 11.10 for a discussion of the possible issuance of a separate report to meet the reporting requirements of *Government Auditing Standards*): (a) an opinion on the financial statement(s) of the federal program and (b) a report on compliance with requirements applicable to the federal program and on the internal control over compliance in accordance with the program-specific audit option under Circular A-133.

D.4. Auditors need to understand the intended purpose of the reports and should tailor the reporting to the specific auditee's situation. Because the reports issued to comply with Circular A-133 involve varying levels of materiality and different forms of reporting, auditors should exercise care in issuing reports to ensure that they meet all of the varying reporting requirements of GAAS, *Government Auditing Standards*, and Circular A-133. Professional judgment should be exercised in any situation not specifically addressed in this SOP.

D.5. The following example auditor's reports illustrate the types of reports to be issued in selected situations. Chapters 10 and 11 of this SOP include discussions of certain of the situations and the resulting reports contained herein. For additional guidance the auditor should refer to SAS No. 58, *Reports on Audited Financial Statements*.

D.6. The following is a list of the example reports in this appendix:

<i>Example No.</i>	<i>Title</i>
1	Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity
1a	Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization
2	Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> (No Reportable Instances of Noncompliance and No Material Weaknesses [No Reportable Conditions Identified])
2a	Report on Compliance and on Internal Control Over Financial Reporting Based on an Audit of Financial Statements Performed in Accordance With <i>Government Auditing Standards</i> (<i>Reportable Instances of Noncompliance and Reportable Conditions Identified</i>)
3	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified]</i>)
3a	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Qualified Opinion on Compliance and Reportable Conditions Identified</i>)
4	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Qualified Opinion on Compliance—Scope Limitation for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, Reportable Conditions Identified</i>)
5	Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (<i>Adverse Opinion on Compliance for One Major Program, Unqualified Opinion on Compliance for Other Major Programs, and Material Weaknesses Identified</i>)
6	Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133
6a	Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133 (<i>Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified]</i>)

Example 1

Unqualified Opinion on General-Purpose Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Governmental Entity¹

Independent Auditor's Report

[Addressee]

We have audited the accompanying general-purpose financial statements of the City of Example, Any State, as of and for the year ended June 30, 19X1, as listed in the table of contents. These general-purpose financial statements are the responsibility of the City of Example's management. Our responsibility is to express an opinion on these general-purpose financial statements based on our audit.

We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,² issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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 the significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the general-purpose financial statements referred to above present fairly, in all material respects, the financial position of the City of Example, Any State, as of June 30, 19X1, and the results of its operations and the cash flows of its proprietary fund types and nonexpendable trust funds for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of the City of Example's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.³ That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The accompanying schedule of expenditures of federal awards⁴ is presented for purposes of additional analysis as required by U.S. Office of Management and

¹ Auditors may also refer to the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* for additional guidance on reporting on the general-purpose financial statements of a government.

² The standards applicable to financial audits include the general, fieldwork, and reporting standards described in chapters 3, 4, and 5 of *Government Auditing Standards*.

³ The following paragraph should be deleted if the schedule of expenditures of federal awards is not presented with the general-purpose financial statements (that is, a separate single audit package is issued). In such a circumstance, the required reporting on the schedule may be incorporated in the report issued to meet the requirements of Circular A-133. See footnotes 34 and 40 for additional guidance.

⁴ If the auditor is reporting on additional supplementary information (for example, combining and individual fund and account group financial statements and schedules), this paragraph should be modified to describe the additional supplementary information. The example reports in appendix A of the AICPA Audit and Accounting Guide *Audits of State and Local Governmental Units* and SAS No. 29, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents* (AICPA, *Professional Standards*, vol. 1, AU sec. 551), provide useful guidance.

Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, and is not a required part of the general-purpose financial statements. Such information has been subjected to the auditing procedures applied in the audit of the general-purpose financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the general-purpose financial statements taken as a whole.⁵

[*Signature*]

[*Date*]

⁵ When reporting on the supplementary information, the auditor should consider the effect of any modifications to the report on the general-purpose financial statements. Furthermore, if the report on supplementary information is other than unqualified, this paragraph should be modified. Guidance for reporting in these circumstances is described in paragraphs 9 through 11, 13, and 14 of SAS No. 29 (AICPA, *Professional Standards*, vol. 1, AU sec. 551.09-.11, .13, and .14).

Example 1a

Unqualified Opinion on Financial Statements and Supplementary Schedule of Expenditures of Federal Awards—Not-for-Profit Organization⁶

Independent Auditor's Report

[Addressee]

We have audited the accompanying statement of financial position of Example NFP as of June 30, 19X1, and the related statements of activities and cash flows⁷ for the year then ended. These financial statements are the responsibility of Example NFP'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 and the standards applicable to financial audits contained in *Government Auditing Standards*,⁸ issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the 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 the 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 Example NFP as of June 30, 19X1, and the changes in its net assets and its cash flows for the year then ended in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example NFP's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants.⁹ That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be read in conjunction with this report in considering the results of our audit.

The accompanying schedule of expenditures of federal awards¹⁰ is presented for purposes of additional analysis as required by U.S. Office of Management and Budget Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*, 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.¹¹

[Signature]

[Date]

⁶ Auditors may also refer to the AICPA Audit and Accounting Guide *Not-For-Profit Organizations* for additional guidance on reporting on the financial statements of a not-for-profit organization.

⁷ If the not-for-profit organization is a voluntary health and welfare organization, this phrase should be modified to state "and the related statements of activities, functional expenses and cash flows."

⁸ See footnote 2.

⁹ See footnote 3.

¹⁰ If the auditor is reporting on additional supplementary information (for example, a comparison of actual and budgeted expenses), this paragraph should be modified to describe the additional supplementary information. SAS No. 29 provides useful guidance.

¹¹ See footnote 5.

Example 2

**Report on Compliance and on Internal Control Over
Financial Reporting¹² Based on an Audit of Financial
Statements Performed in Accordance With Government
Auditing Standards (No Reportable Instances of
Noncompliance and No Material Weaknesses [No
Reportable Conditions Identified])¹³**

[Addressee]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.¹⁴ We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,¹⁵ issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.^{16, 17}

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the

¹² See paragraph 4.12 for a description of internal control over financial reporting.

¹³ The auditor should use the portions of examples 2 and 2a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 2a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 2a.

¹⁴ Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors).

¹⁵ See footnote 2.

¹⁶ See paragraphs 5.18 and 5.19 of *Government Auditing Standards* for the criteria for reporting.

¹⁷ If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "However, we noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with paragraph 5.20 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses.¹⁸

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and 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.^{19, 20}

[*Signature*]

[*Date*]

¹⁸ If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "However, we noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

¹⁹ If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and [*specify legislative or regulatory body*] and is not intended to be and should not be used by anyone other than these specified parties."

²⁰ This paragraph conforms to SAS No. 87, *Restricting the Use of an Auditor's Report* (AICPA, *Professional Standards*, vol. 1, AU sec. 532). See SAS No. 87 for additional guidance on restricted-use reports.

Example 2a

**Report on Compliance and on Internal Control Over
Financial Reporting²¹ Based on an Audit of Financial
Statements Performed in Accordance With Government
Auditing Standards (Reportable Instances of
Noncompliance and Reportable Conditions Identified)²²**

[Addressee]

We have audited the financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1.²³ We conducted our audit in accordance with generally accepted auditing standards and the standards applicable to financial audits contained in *Government Auditing Standards*,²⁴ issued by the Comptroller General of the United States.

Compliance

As part of obtaining reasonable assurance about whether Example Entity's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit, and accordingly, we do not express such an opinion. The results of our tests disclosed instances of noncompliance that are required to be reported under *Government Auditing Standards*²⁵ and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-2 and 97-5].²⁶

Internal Control Over Financial Reporting

In planning and performing our audit, we considered Example Entity's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain matters involving the internal control over financial reporting and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over financial reporting that, in our judgment, could adversely affect Example Entity's ability to record, process, summarize, and report financial data consistent with the

²¹ See footnote 12.

²² See footnote 13.

²³ See footnote 14.

²⁴ See footnote 2.

²⁵ See footnote 16.

²⁶ If the auditor has issued a separate letter to management to communicate matters that do not meet the criteria for reporting in paragraph 5.18 of *Government Auditing Standards*, this paragraph should be modified to include a statement such as the following: "We also noted certain immaterial instances of noncompliance, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference to management is intended to be consistent with chapter 5, paragraph 5.20 of *Government Auditing Standards*, which indicates that communications to "top" management should be referred to.

assertions of management in the financial statements. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-1, 97-4, and 97-8*].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{27, 28}

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and 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.^{29, 30}

[*Signature*]

[*Date*]

²⁷ If conditions believed to be material weaknesses are disclosed, the report should identify the material weaknesses that have come to the auditor's attention. The last sentence of this paragraph should be replaced with language such as the following: "However, of the reportable conditions described above, we consider items [*list the reference numbers of the related findings, for example, 97-1 and 97-8*] to be material weaknesses."

²⁸ If the auditor has issued a separate letter to management to communicate other matters involving the design and operation of the internal control over financial reporting, this paragraph should be modified to include a statement such as the following: "We also noted other matters involving the internal control over financial reporting, which we have reported to management of Example Entity in a separate letter dated August 15, 19X1." This reference is not intended to preclude the auditor from including other matters in the separate letter to management. Furthermore, the reference to management is intended to be consistent with paragraph 5.28 of *Government Auditing Standards* which indicates that communications to "top" management should be referred to.

²⁹ If this report is issued for an audit that is not subject to Circular A-133, this sentence should be modified as follows: "This report is intended solely for the information and use of the audit committee, management, and [*specify legislative or regulatory body*] and is not intended to be and should not be used by anyone other than these specified parties." All references to the schedule of findings and questioned costs should also be removed, and instead, a description of the findings should be included in the report.

³⁰ See footnote 20.

Example 3

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])³¹

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,³² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-3 and 97-6].³³

³¹ The auditor should use the portions of examples 3 and 3a that apply to a specific auditee situation. For example, if the auditor will be giving an unqualified opinion on compliance but has identified reportable conditions, the compliance section of this report would be used along with the internal control section of example 3a. Alternatively, if the auditor will be giving a qualified opinion on compliance but has not identified reportable conditions, the internal control section of this report would be used along with the compliance section of example 3a.

³² See footnote 2.

³³ When there are no such instances of noncompliance identified in the schedule of findings and questioned costs, the last sentence should be omitted.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.³⁴

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and 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.³⁵

[Signature]

[Date]

³⁴ As noted in notes 3 and 9, there may be instances in which it would be appropriate to report on the schedule of expenditures of federal awards in this report (that is, a separate single audit package is issued). In such a circumstance, a new section should be added immediately following this paragraph as follows:

Schedule of Expenditures of Federal Awards

We have audited the [*general-purpose or basic*] financial statements of Example Entity as of and for the year ended June 30, 19X1, and have issued our report thereon dated August 15, 19X1. Our audit was performed for the purpose of forming an opinion on the [*general-purpose or basic*] financial statements taken as a whole. The accompanying schedule of expenditures of federal awards is presented for purposes of additional analysis as required by OMB Circular A-133 and is not a required part of the [*general-purpose or basic*] financial statements. Such information has been subjected to the auditing procedures applied in the audit of the [*general-purpose or basic*] financial statements and, in our opinion, is fairly stated, in all material respects, in relation to the [*general-purpose or basic*] financial statements taken as a whole.

Describe any departure from the standard report (for example, a qualified opinion, a modification as to consistency because of a change in accounting principle, or a reference to the report of other auditors). Auditors should also refer to notes 5 and 11 for additional guidance.

³⁵ See footnote 20.

Example 3a

Report on Compliance With Requirements Applicable to Each Major Program and on Internal Control Over Compliance in Accordance With OMB Circular A-133 (Qualified Opinion on Compliance and Reportable Conditions Identified)³⁶

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,³⁷ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in item [list the reference numbers of the related findings, for example, 97-10] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [identify the type(s) of compliance requirement] that are applicable to its [identify the major federal program]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with the requirements applicable to that program.

In our opinion, except for the noncompliance described in the preceding paragraph, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its major federal programs for the year ended June 30, 19X1.³⁸

³⁶ See footnote 31.

³⁷ See footnote 2.

³⁸ When other instances of noncompliance are identified in the schedule of findings and questioned costs as required by Circular A-133, the following sentence should be added: "The results of our auditing procedures also disclosed other instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-3 and 97-6]."

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items [*list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9*].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{39, 40}

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and 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.⁴¹

[*Signature*]

[*Date*]

³⁹ See footnote 27.

⁴⁰ See footnote 34.

⁴¹ See footnote 20.

Example 4

**Report on Compliance With Requirements Applicable to
Each Major Program and on Internal Control Over
Compliance in Accordance With OMB Circular A-133
(Qualified Opinion on Compliance—Scope Limitation for
One Major Program, Unqualified Opinion on
Compliance for Other Major Programs, Reportable
Conditions Identified)**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

Except as discussed in the following paragraph, we conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,⁴² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

We were unable to obtain sufficient documentation supporting the compliance of Example Entity with [identify the major federal program] regarding [identify the type(s) of compliance requirement], nor were we able to satisfy ourselves as to Example Entity's compliance with those requirements by other auditing procedures.

In our opinion, except for the effects of such noncompliance, if any, as might have been determined had we been able to examine sufficient evidence regarding Example Entity's compliance with the requirements of [identify the major federal program] regarding [identify the type(s) of compliance requirement], Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.⁴³

⁴² See footnote 2.

⁴³ See footnote 38.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as *items* [list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9].

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, we believe that none of the reportable conditions described above is a material weakness.^{44, 45}

This report is intended solely for the information and use of the audit committee, management, [specify legislative or regulatory body], and 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.⁴⁶

[Signature]

[Date]

⁴⁴ See footnote 27.

⁴⁵ See footnote 34.

⁴⁶ See footnote 20.

Example 5

**Report on Compliance With Requirements Applicable to
Each Major Program and on Internal Control Over
Compliance in Accordance With OMB Circular A-133
(Adverse Opinion on Compliance for One Major Program,
Unqualified Opinion on Compliance for Other Major
Programs, and Material Weaknesses Identified)**

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to each of its major federal programs for the year ended June 30, 19X1. Example Entity's major federal programs are identified in the summary of auditor's results section of the accompanying schedule of findings and questioned costs. Compliance with the requirements of laws, regulations, contracts, and grants applicable to each of its major federal programs is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,⁴⁷ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on a major federal program occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

As described in items [list the reference numbers of the related findings, for example, 97-10, 97-11, and 97-12] in the accompanying schedule of findings and questioned costs, Example Entity did not comply with requirements regarding [identify the types of compliance requirements] that are applicable to its [identify the major federal program]. Compliance with such requirements is necessary, in our opinion, for Example Entity to comply with requirements applicable to that program.

In our opinion, because of the effects of the noncompliance described in the preceding paragraph, Example Entity did not comply in all material respects, with the requirements referred to above that are applicable to [identify the major federal program]. Also, in our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to each of its other major federal programs for the year ended June 30, 19X1.⁴⁸

⁴⁷ See footnote 2.

⁴⁸ See footnote 38.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on a major federal program in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

We noted certain matters involving the internal control over compliance and its operation that we consider to be reportable conditions. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control over compliance that, in our judgment, could adversely affect Example Entity's ability to administer a major federal program in accordance with the applicable requirements of laws, regulations, contracts, and grants. Reportable conditions are described in the accompanying schedule of findings and questioned costs as items *[list the reference numbers of the related findings, for example, 97-7, 97-8, and 97-9]*.

A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be reportable conditions and, accordingly, would not necessarily disclose all reportable conditions that are also considered to be material weaknesses. However, of the reportable conditions described above, we consider items *[list the reference numbers of the related findings, for example 97-8 and 97-9]* to be material weaknesses.⁴⁹

This report is intended solely for the information and use of the audit committee, management, *[specify legislative or regulatory body]*, and 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.⁵⁰

[Signature]

[Date]

⁴⁹ See footnote 34.

⁵⁰ See footnote 20.

Example 6

Unqualified Opinion on the Financial Statement of a Federal Program in Accordance With the Program-Specific Audit Option Under OMB Circular A-133

Independent Auditor's Report

We have audited the accompanying schedule of expenditures of federal awards for the [identify the federal program] of Example Entity for the year ended June 30, 19X1. This financial statement is the responsibility of Example Entity's management. Our responsibility is to express an opinion on the financial statement of the program based on our audit.⁵¹

We conducted our audit in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,⁵² issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and the 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 schedule of expenditures of federal awards referred to above⁵³ presents fairly, in all material respects, the expenditures of federal awards under the [identify the federal program] in conformity with generally accepted accounting principles.^{54, 55}

[Signature]

[Date]

⁵¹ In many cases, the financial statements of the program will consist only of the schedule of expenditures of federal awards (and notes to the schedule), which is the minimum financial statement presentation required by section 235 of Circular A-133. If the auditee issues financial statements that consist of more than the schedule, this paragraph should be modified to describe the financial statements. Also refer to paragraph 11.10 for a discussion of the possible necessity to issue a separate report to meet the reporting requirements of *Government Auditing Standards*.

⁵² See footnote 2.

⁵³ If the auditee issues financial statements that consist of more than the schedule, this sentence should be modified to identify the results displayed in the financial presentation.

⁵⁴ The auditor should follow the guidance in SAS No. 62, *Special Reports* when the auditee prepares the financial statement of the program in conformity with a basis of accounting other than GAAP.

⁵⁵ If a separate report is issued to meet the reporting requirements of *Government Auditing Standards* (see paragraph 11.10), an additional paragraph should be added as follows: "In accordance with *Government Auditing Standards*, we have also issued our report dated [date of report] on our consideration of Example Entity's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants."

Example 6a

Report on Compliance With Requirements Applicable to the Federal Program and on Internal Control Over Compliance in Accordance With the Program-Specific Audit Option Under OMB Circular A-133⁵⁶ (Unqualified Opinion on Compliance and No Material Weaknesses [No Reportable Conditions Identified])⁵⁷

[Addressee]

Compliance

We have audited the compliance of Example Entity with the types of compliance requirements described in the *U.S. Office of Management and Budget (OMB) Circular A-133 Compliance Supplement* that are applicable to [identify the federal program] for the year ended June 30, 19X1. Compliance with the requirements of laws, regulations, contracts, and grants applicable to its major federal program is the responsibility of Example Entity's management. Our responsibility is to express an opinion on Example Entity's compliance based on our audit.

We conducted our audit of compliance in accordance with generally accepted auditing standards; the standards applicable to financial audits contained in *Government Auditing Standards*,⁵⁸ issued by the Comptroller General of the United States; and OMB Circular A-133, *Audits of States, Local Governments, and Non-Profit Organizations*. Those standards and OMB Circular A-133 require that we plan and perform the audit to obtain reasonable assurance about whether noncompliance with the types of compliance requirements referred to above that could have a direct and material effect on [identify the federal program] occurred. An audit includes examining, on a test basis, evidence about Example Entity's compliance with those requirements and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion. Our audit does not provide a legal determination of Example Entity's compliance with those requirements.

In our opinion, Example Entity complied, in all material respects, with the requirements referred to above that are applicable to its [identify the federal program] for the year ended June 30, 19X1. However, the results of our auditing procedures disclosed instances of noncompliance with those requirements, which are required to be reported in accordance with OMB Circular A-133 and which are described in the accompanying schedule of findings and questioned costs as items [list the reference numbers of the related findings, for example, 97-1 and 97-2].⁵⁹

⁵⁶ This is an example of a report on a program-specific audit under Circular A-133 when no federal audit guide applicable to the program being audited is available. When a federal audit guide applicable to the program is available, Circular A-133 requires that the auditor follow the reporting requirements of that federal audit guide (see paragraph 11.4 for a discussion of the auditor's responsibility when a program-specific audit guide is not current).

⁵⁷ If issuing a qualified or adverse opinion on compliance, the auditor should modify the compliance section of this report to be consistent with the wording used in examples 3a or 5, accordingly. If reporting reportable conditions, including material weaknesses, the auditor should modify the internal control section of this report to be consistent with the wording used in example 3a.

⁵⁸ See footnote 2.

⁵⁹ See footnote 33.

Internal Control Over Compliance

The management of Example Entity is responsible for establishing and maintaining effective internal control over compliance with the requirements of laws, regulations, contracts, and grants applicable to federal programs. In planning and performing our audit, we considered Example Entity's internal control over compliance with requirements that could have a direct and material effect on its [*identify the federal program*] in order to determine our auditing procedures for the purpose of expressing our opinion on compliance and to test and report on the internal control over compliance in accordance with OMB Circular A-133.

Our consideration of the internal control over compliance would not necessarily disclose all matters in the internal control that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that noncompliance with the applicable requirements of laws, regulations, contracts, and grants that would be material in relation to a major federal program being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. We noted no matters involving the internal control over compliance and its operation that we consider to be material weaknesses.

This report is intended solely for the information and use of the audit committee, management, [*specify legislative or regulatory body*], and the federal awarding agency and pass-through entity and is not intended to be and should not be used by anyone other than these specified parties.⁶⁰

[*Signature*]

[*Date*]

⁶⁰ See footnote 20.

Appendix E

Illustrative Schedule of Findings and Questioned Costs

Example Entity
Schedule of Findings and Questioned Costs
For the Year Ended June 30, 19X1

Section I—Summary of Auditor’s Results

Financial Statements

Type of auditor’s report issued [*unqualified, qualified, adverse, or disclaimer*]:

Internal control over financial reporting:

- Material weakness(es) identified? _____ yes _____ no
- Reportable condition(s) identified that are not considered to be material weaknesses? _____ yes _____ none reported

Noncompliance material to financial statements noted? _____ yes _____ no

Federal Awards

Internal control over major programs:

- Material weakness(es) identified? _____ yes _____ no
- Reportable condition(s) identified that are not considered to be material weakness(es)? _____ yes _____ none reported

Type of auditor’s report issued on compliance for major programs [*unqualified, qualified, adverse, or disclaimer*]:¹

Any audit findings disclosed that are required to be reported in accordance with section 510(a) of Circular A-133? _____ yes _____ no

Identification of major programs:²

<u>CFDA Number(s)</u> ³	<u>Name of Federal Program or Cluster</u> ⁴

¹ If the audit report for one or more major programs is other than unqualified, indicate the type of report issued for each program. For example, if the audit report on major program compliance for an auditee having five major programs includes an unqualified opinion for three of the programs, a qualified opinion for one program, and a disclaimer of opinion for one program, the response to this question could be as follows: “Unqualified for all major programs except for [name of program], which was qualified and [name of program], which was a disclaimer.”

² Major programs should generally be identified in the same order as reported on the schedule of expenditures of federal awards.

³ When the CFDA number is not available, include other identifying number, if applicable.

⁴ The name of the federal program or cluster should be the same as that listed in the schedule of expenditures of federal awards. For clusters, auditors are only required to list the name of the cluster and not each individual program within the cluster.

Dollar threshold used to distinguish
between type A and type B programs: \$ _____

Auditee qualified as low-risk auditee? _____ yes _____ no

Section II—Financial Statement Findings

[This section identifies the reportable conditions, material weaknesses, and instances of noncompliance related to the financial statements that are required to be reported in accordance with paragraphs 5.18 through 5.20 of Government Auditing Standards. Auditors should refer to those paragraphs, as well as the reports content section of chapter 7 of Government Auditing Standards, for additional guidance on preparing this section of the schedule.]

Identify each finding with a reference number.⁵ If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a material weakness in internal control that effects an entity as a whole, including its federal awards, would generally be reported in detail in this section. Section III would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:

- *Criteria or specific requirement*
- *Condition*
- *Questioned costs*
- *Context⁶*
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response⁷*

Section III—Federal Award Findings and Questioned Costs

[This section identifies the audit findings required to be reported by section 510(a) of Circular A-133 (for example, reportable conditions, material weaknesses, and instances of noncompliance, including questioned costs). Where practical, findings should be organized by federal agency or pass-through entity.]

Identify each finding with a reference number.⁸ If there are no findings, state that no matters were reported. Audit findings that relate to both the financial statements and federal awards should be reported in both section II and section

⁵ A suggested format for assigning reference numbers is to use the last two digits of the fiscal year being audited, followed by a numeric sequence of findings. For example, findings identified and reported in the audit of fiscal year 1997 would be assigned reference numbers of 97-1, 97-2, etc.

⁶ Provide sufficient information for judging the prevalence and consequences of the finding, such as the relation to the universe of costs and/or the number of items examined and quantification of audit findings in dollars.

⁷ See paragraphs 5.18 through 5.20 and 7.38 through 7.42 of *Government Auditing Standards* for additional guidance on reporting management's response.

⁸ See footnote 5.

III. However, the reporting in one section may be in summary form with a reference to a detailed reporting in the other section of the schedule. For example, a finding of noncompliance with a federal program law that is also material to the financial statements would generally be reported in detail in this section. Section II would then include a summary identification of the finding and a reference back to the specific finding in this section. Each finding should be presented in the following level of detail, as applicable:

- *Information on the federal program*⁹
- *Criteria or specific requirement (including statutory, regulatory, or other citation)*
- *Condition*¹⁰
- *Questioned costs*¹¹
- *Context*¹²
- *Effect*
- *Cause*
- *Recommendation*
- *Management's response*¹³

⁹ Provide the federal program (CFDA number and title) and agency, the federal award's number and year, and the name of the pass-through entity, if applicable. When this information is not available, the auditor should provide the best information available to describe the federal award.

¹⁰ Include facts that support the deficiency identified in the audit finding.

¹¹ Identify questioned costs as required by sections 510(a)(3) and 510(a)(4) of Circular A-133.

¹² See footnote 6.

¹³ To the extent practical, indicate when management does not agree with the finding, questioned cost, or both.

AICPA Single Audit Working Group

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[The next page is 31,285.]

Section 11,330

Statement of Position 98-6 Reporting on Management's Assessment Pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association

April 9, 1998

NOTE

This Statement of Position presents the recommendations of the AICPA Insurance Companies Committee regarding the application of Statements on Standards for Attestation Engagements to engagements to report on management's assessment pursuant to the Life Insurance Ethical Market Conduct Program of the Insurance Marketplace Standards Association. Members of the AICPA Auditing Standards Board have found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

Summary

This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an independent examination performed pursuant to the AICPA Statement on Standards for Attestation Engagements to assist an entity in meeting the requirements of the Insurance Marketplace Standards Association (IMSA) program (the IMSA program). IMSA requires that such engagements use the criteria it sets forth; consequently, users of this SOP should be familiar with the IMSA program and its *Assessment Handbook* and requirements.

The SOP amends chapter 9, "Auditor's Reports," of the AICPA Audit and Accounting Guide *Audits of Property and Liability Insurance Companies* and chapter 11, "Auditors' Reports," of the AICPA Industry Audit Guide *Audits of Stock Life Insurance Companies*. It is effective for independent assessments with IMSA report dates after January 31, 1998.

Introduction and Background

.01 Within the past several years, the life insurance industry has experienced allegations of improper market conduct practices such as questionable sales practices and potentially misleading policyholder illustrations. These allegations have triggered regulatory scrutiny, class action litigation, significant monetary settlements, and negative publicity related to market conduct issues. As a result, the industry is taking steps to promote a higher standard of ethical behavior that it hopes will reverse the negative perceptions held by many customers. In that regard, the American Council of Life Insurers (ACLI),

the largest life insurance trade organization, has established the Insurance Marketplace Standards Association (IMSA) as a nonaffiliated membership organization with its own board of directors composed of chief executives of life insurance companies. IMSA seeks to encourage and assist participating life insurance entities (hereinafter referred to as entities) in the design and implementation of sales and marketing policies and procedures that are intended to benefit and protect the consumer. Entities that desire to join IMSA will be required to adopt the IMSA Principles of Ethical Market Conduct (the Principles) and the Code of Ethical Market Conduct (the Code) and Accompanying Comments and respond affirmatively to an assessment questionnaire (the Questionnaire). Each prospective member also will be required to conduct a self-assessment to determine that it has policies and procedures in place that will enable it to respond affirmatively to the Questionnaire. An entity's self-assessment responses to the Questionnaire will need to be validated by an independent examination of the self-assessment. On obtaining an unqualified third-party assessment report, entities will be eligible for IMSA membership. Membership in IMSA is valid for a three-year period. Members are permitted to use IMSA's logo subject to rules set forth by IMSA for advertising and other promotional activities. The assessment process is intended to encourage entities and help them continually review and modify their policies and procedures in order to improve their market conduct practices and those of the industry and to strengthen consumer confidence in the life insurance business.

.02 Certified public accountants in the practice of public accounting (herein referred to as practitioners as defined by Statement on Standards for Attestation Engagements [SSAE] No. 1, *Attestation Standards* [AICPA, *Professional Standards*, vol. 1, AT sec. 100, "Attestation Engagements"]), may be engaged to examine and/or provide various consulting services related to the entity's self-assessment. This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an independent examination performed pursuant to the American Institute of Certified Public Accountants (AICPA) SSAEs to assist an entity in meeting the requirements of the IMSA Life Insurance Ethical Market program (the IMSA program). As described herein, IMSA requires that such engagements use the criteria it sets forth; consequently, users of this SOP should be familiar with the IMSA program and its *Assessment Handbook* and requirements.

Scope

.03 This SOP applies to engagements to report on an entity's assertion that the affirmative responses to the Questionnaire relating to the IMSA Principles and Code and Accompanying Comments are based on policies and procedures in place at the IMSA report date. Reporting on assertions made in connection with the IMSA program are examination engagements that should be performed under SSAE No. 1 (AT sec. 100).

Overview of the IMSA Life Insurance Ethical Market Conduct Program

Principles of Ethical Market Conduct

.04 The Principles consist of six statements that set certain standards with respect to the sale and service of individually sold life and annuity products. The Principles that the entity is required to adopt are as follows:

Principle 1

To conduct business according to high standards of honesty and fairness and to render that service to its customers which, in the same circumstances, it would apply to or demand for itself.

Principle 2

To provide competent and customer-focused sales and service.

Principle 3

To engage in active and fair competition.

Principle 4

To provide advertising and sales materials that are clear as to purpose and honest and fair as to content.

Principle 5

To provide for fair and expeditious handling of customer complaints and disputes.

Principle 6

To maintain a system of supervision and review that is reasonably designed to achieve compliance with these Principles of Ethical Market Conduct.

.05 IMSA developed the Code of Ethical Market Conduct to expand the Principles of Ethical Market Conduct to the operating level and to identify the attributes of the sales, marketing, and compliance systems that IMSA believes should support each of the Principles.

.06 To further expand on the Principles and Code, IMSA developed Accompanying Comments, which further define the intention of the Principles and Code and, in some instances, provide examples of implementation.

IMSA Assessment Questionnaire

.07 As noted above, IMSA developed the Questionnaire to provide prospective members with uniform criteria to demonstrate for self-assessment purposes that they have policies and procedures in place that meet the objective of the questions in the Questionnaire.

Insurance Marketplace Standards Association Membership and Certification Process

.08 Participation in the IMSA program requires an entity to adopt the Principles and Code and to undertake a two-step assessment process. First, an entity conducts a self-assessment, using the Questionnaire and *Assessment Handbook*, with the objective of concluding that it can respond affirmatively to every question in the Questionnaire in conformity with the criteria set forth in IMSA's Principles, Code, and Accompanying Comments. Second, an independent assessor from a list of IMSA-approved assessors examines the self-assessment materials to determine whether the entity has a reasonable basis for its affirmative responses to the Questionnaire.

.09 Once the assessment process is complete, the entity submits its IMSA Membership Application (the application) and Self-Assessment Report. The Self-Assessment Report states that the entity has adopted the Principles and

Code, has conducted a self-assessment of its policies and procedures, and has determined that the answer to each of the questions in the Questionnaire is “yes” in conformity with the *Assessment Handbook*. The entity also submits an unqualified examination report from an IMSA-approved independent assessor.

IMSA Independent Assessor Application Process and Required Training

.10 IMSA will accept independent assessor reports only from those assessors that have been preapproved by IMSA. To become an independent assessor, a candidate is required to submit an IMSA Independent Assessor Application that requires that the candidate meet specific educational and professional requirements established by the IMSA board of directors. IMSA also requires that all independent assessors attend IMSA training as outlined by the board of IMSA. Independent assessors may be of various occupations or professional disciplines, including certified public accountants.

IMSA Assessment Handbook

.11 IMSA developed an *Assessment Handbook* (the Handbook or the IMSA Handbook) to assist companies in the implementation of the IMSA program and provide guidance to independent assessors. Entity personnel and independent assessors should use the Handbook to gain an understanding of the assessment process and as a source of information for performing an assessment. The Handbook is intended for companies of all sizes regardless of the means by which they distribute individually sold life and annuity products. IMSA acknowledges that this is a new program that will evolve over time. Therefore, the Handbook may be revised as companies and independent assessors provide IMSA with suggestions for improvement. Practitioners should ensure that they are utilizing the most current version of the Handbook in planning and performing their work.

Conclusions

Planning the Engagement

.12 To satisfy IMSA program requirements, practitioners need to perform an examination engagement pursuant to SSAE No. 1 (AT sec. 100), which states that planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners should have adequate technical training and proficiency in the attest function and have adequate knowledge in life insurance market conduct and the IMSA program to enable them to sufficiently understand the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

.13 The examination should be made in accordance with standards established by the AICPA, including obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based. To be acceptable to IMSA, the engagement also should be performed in accordance with the criteria set forth in the IMSA Handbook. This SOP is intended to provide neither all the required criteria set forth in the IMSA Handbook nor all the applicable standards established by the AICPA.

.14 In accordance with SSAE No. 1 (AT sec. 100.33–.35) and the Handbook, a practitioner performing the examination should supervise the engagement team, which involves directing the efforts of the engagement team in accomplishing the objectives of the engagement and determining whether the engagement objectives were met. If the practitioner is not an IMSA-approved independent assessor, such an assessor should be a member of the engagement team with responsibility for, among other things, assisting the practitioner in performing these functions.

.15 The engagement team should be informed of its responsibilities, including the objectives of the procedures that they are to perform and matters that may affect the nature, extent, and timing of such procedures. The work performed by each member of the engagement team should be reviewed to determine if it was adequately performed.

.16 IMSA, through its Handbook, has adopted a methodology to foster a uniform determination by entities and their independent assessor on whether policies and procedures are in place. The Handbook requires the following three aspects be present: approach, deployment, and monitoring. (See appendix B, paragraph B-2 [paragraph .38], for further discussion.)

Establishing an Understanding With the Client

.17 The practitioner should consider the risks associated with accepting an engagement to examine and report on an entity's assertion about its responses to the IMSA Questionnaire. The practitioner should establish an understanding with the client regarding the services to be performed. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, limitations of the engagement, provision for changes in the scope of the engagement, and the expected form of the report. The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter. Appendix C [paragraph .39] contains a sample engagement letter that may be used for this type of engagement.

Assessments of Attestation Risk

.18 The practitioner should evaluate the attestation risk that policies and procedures may not be in place to support affirmative responses to the Questionnaire and should consider this risk in designing the attest procedures to be performed. In examining whether policies and procedures are in place, the practitioner determines whether the policies and procedures have been adopted and are in operation and whether such policies and procedures satisfy the six components required by IMSA for the entity to respond affirmatively to each question, as discussed in appendix B [paragraph .38]. Whether an entity has policies and procedures in place does not encompass whether those policies and procedures operated effectively as of a particular date, or over any period of time, to ensure compliance with the Principles, Code, and Accompanying Comments or about whether the entity or its employees have complied with applicable laws and regulations.

.19 Examples of risk considerations that may affect the nature, timing, and extent of testing procedures are listed in appendix A [paragraph .37]. Not all the examples are relevant in all circumstances, and some may be of greater or lesser significance in entities of different size, distribution channels, product lines, or sales volume. In determining the examination procedures to be performed, practitioners should assess the impact that those risk considerations, individually and in combination, may have on attestation risk.

.20 Before performing attestation procedures, the practitioner should be adequately trained and should obtain an understanding of the entity's overall operations and market conduct practices, as well as its policies and procedures that have been identified in the self-assessment as supporting its affirmative responses to the Questionnaire. In addition, the practitioner should obtain an understanding of the operation and history of the entity's distribution systems and products sold and of sales volume by product and distribution system. The practitioner should also obtain an understanding of the entity's past market conduct issues and related corrective measures.

Evidential Matter

.21 In an examination engagement performed under the attestation standards, the practitioner's objective is to accumulate sufficient evidence to limit attestation risk to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. In such an engagement, the practitioner should select from all available procedures any combination that can limit attestation risk to such an appropriately low level. Accordingly, in an examination engagement it is necessary for a practitioner's procedures to go beyond reading relevant policies and procedures and making inquiries of appropriate members of management to determine whether the policies and procedures supporting affirmative responses to the Questionnaire were in place. Examination procedures should also include verification procedures, such as inspecting documents and records, confirming assertions with employees or agents, and observing activities. See appendix B [paragraph .38] for examples of illustrative procedures.

.22 As outlined in the Handbook, the entity should provide the practitioner with adequate information for the practitioner to obtain reasonable assurance that there is a basis for an affirmative response to each of the questions in the Questionnaire. The AICPA's concept of reasonable assurance in the context of an attestation engagement is set forth in SSAE No. 2, *Reporting on an Entity's Internal Control Over Financial Reporting* (AICPA, *Professional Standards*, vol. 1, AT sec. 400.13), and SSAE No. 3, *Compliance Attestation* (AICPA, *Professional Standards*, vol. 1, AT sec. 500.30). These concepts are consistent with IMSA's concept of reasonable assurance as defined in the Handbook.¹

.23 In an examination of management's assertion about an entity's affirmative responses to the Questionnaire, the practitioner's evaluation of sufficiency and competency of evidential matter should include consideration of (a) the nature of management's assertion and the related indicators used to support such assertions, (b) the nature and frequency of deviations from expected results of applying examination procedures, and (c) qualitative considerations, including the needs and expectations of the report's users.

Reporting Considerations

.24 SSAE No. 1 (AT sec. 100) defines an attest engagement as one in which a practitioner is engaged to issue a written communication that expres-

¹ *Reasonable (assurance)* is defined in the Handbook as follows: "In the context of the IMSA program documents, the term *reasonable* is used to modify assurance, as an acknowledgment that it is virtually impossible to provide absolute and certain assurance that an event will happen (e.g., that a policy will address every possible circumstance, or that procedures will be applied without exception). *Reasonable*, as a qualifier, suggests that there exists a standard in both design and performance, and that such a standard, while conforming to the judgment or discernment of a knowledgeable person, is neither excessive nor extreme."

ses a conclusion about the reliability of a written assertion that is the responsibility of another party. The accompanying affirmative responses to the questions in the Questionnaire are written assertions of the entity. When a practitioner is engaged by an entity to express a written conclusion about management's assertions about its policies and procedures, such an engagement involves a written conclusion about the reliability of an assertion that is the responsibility of the entity. The entity is responsible for the design, implementation, and monitoring of the policies and procedures upon which the responses to the Questionnaire are based.

.25 Self-assessment is based in part on criteria set forth in the IMSA Handbook, which is prepared by an industry organization for the specific use of its members. Such criteria are not suitable for general distribution reporting. Accordingly, the independent accountant's report should contain a statement that it is intended solely for the information and use of the entity's board of directors and management as well as IMSA.

.26 IMSA has adopted a uniform assessment report that all independent assessors (regardless of professional discipline) are required to use when reporting on the results of an independent assessment. IMSA has indicated that deviations from its standard report format, except as discussed below, will not be accepted. The following is an illustration of an independent accountant's report on a company's assertion relating to its affirmative responses to the IMSA Questionnaire. The third paragraph in the following report deviates from the IMSA format, where the practitioner specifies that the examination was made in accordance with standards established by the AICPA, and refers to those standards before referring to the criteria set forth in the IMSA Handbook. The other deviation is that the report is titled "Independent Accountant's Report" rather than "Independent Assessor Report." Representatives of IMSA have indicated that they will accept only these deviations for reports issued by practitioners.

Independent Accountant's Report

To [*name of insurer*] Board of Directors and the Insurance Marketplace Standards Association:

We have examined management's assertion that the affirmative responses of [*name of insurer*] to the Questionnaire relating to the Principles of Ethical Market Conduct and the Code of Ethical Market Conduct and Accompanying Comments for individually sold life and annuity products, adopted by the Insurance Marketplace Standards Association ("IMSA"), are based on policies and procedures in place as of [*the IMSA report date*]. The Company is responsible for the design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire are based.

Our examination was made in accordance with standards established by the American Institute of Certified Public Accountants and in accordance with the criteria set forth in the *IMSA Assessment Handbook*, and included obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion. Our examination was not designed to evaluate whether the policies and procedures, upon which the Company's responses to the Questionnaire are based, have or will operate effectively, nor have we evaluated whether or not the Company has or will comply with applicable laws or regulations. Accordingly, we do not express an opinion or any other form of assurance thereon.

In our opinion, management's assertion that the affirmative responses to the Questionnaire are based on policies and procedures in place as of [the *IMSA report date*] is fairly stated, in all material respects, based upon the criteria set forth in the Principles of Ethical Market Conduct, the Code of Ethical Market Conduct and Accompanying Comments, and the *Assessment Handbook*.

This report is intended solely for the information and use of the board of directors and management of the Company and the Insurance Marketplace Standards Association and should not be used for any other purpose.

[*IMSA Report Date; see paragraph .28*]

[*Company (Insurer)*]

[*Name of Independent Assessor; see paragraph .27*]

[*Signature of Independent Accountant or Firm*]

[*Date of Signature; see paragraph .29*]

Note: In any instance where an alternative indicator is used to support an affirmative answer to any question in the Questionnaire, such alternative indicator must be fully set forth in an attachment to this Assessor Report (see paragraph .30).

Elements of the Report

.27 Signatures and Identification of the Independent Assessor. IMSA prefers that the independent assessor sign his or her name on the report. However, many AICPA member firms require that a manual or printed signature of the firm name be presented on the face of the report and prohibit a member of the firm from signing the report as an individual. Although IMSA will accept this practice, it requires the identification on the face of the independent accountant's report of the IMSA-approved independent assessor who actively participated in and supervised relevant portions of the engagement on behalf of the firm. In addition, in circumstances where the IMSA-approved independent assessor does not sign the report as an individual, IMSA requires an affirmation from the independent assessor to be attached to the independent accountant's report. A sample affirmation follows:

Affirmation of Independent Assessor

I, [print name], affirm that I have reviewed the attached Independent Accountant's Report on management's assertions regarding the IMSA program for [insurer] as of [IMSA report date] and that I was the Independent Assessor responsible for supervising relevant portions of the assessment identified herein.

[Signature]

[Date of Signature]

.28 IMSA Report Date. The IMSA report date referred to in the independent accountant's report is the date of the self-assessment and the date to which the entity and the independent assessor have agreed as the point in time which the policies and procedures supporting the affirmative response to the Questionnaire are in place. Due care should be taken to ensure that representations made by management on the basis of a self-assessment are current as of the IMSA report date. If a significant amount of time has elapsed between the date of the performance of the practitioner's procedures on certain questions and the IMSA report date, due care should be taken to ensure that policies and procedures were in place as of the IMSA report date.

.29 Date of Signature. The date of signature is the date fieldwork is completed. Changes in the policies and procedures, personnel changes, or other considerations that might significantly affect responses to the Questionnaire may occur subsequent to the IMSA report date but before the date of signature or the date when the report is issued. The practitioner should obtain management's representations relating to such matters and perform such other procedures regarding subsequent events considered necessary in the circumstances. The practitioner has no responsibility to perform examination procedures or update his or her report for events subsequent to the date when the report is issued; however, the practitioner may later become aware of conditions that existed at that date that might have affected the practitioner's opinion had he or she been aware of them. The practitioner's consideration of such subsequent information is similar to an auditor's consideration of information discovered subsequent to the date of a report on an audit of financial statements described in SAS No. 1 (AICPA, *Professional Standards*, vol. 1, AU sec. 561, "Subsequent Discovery of Facts Existing at the Date of the Auditor's Report").

.30 Alternative Indicators. A list of indicators in the Handbook corresponds to each of the questions in the Questionnaire and lists possible policies and procedures identified by IMSA that an entity can have in place to be able to respond affirmatively to a question. A company must support each "yes" response to a question by the selection of indicators sufficient to meet the six required components and to meet the objective of each question. IMSA has established limitations on the use of indicators other than those contained in the Handbook. Alternative indicators that are used as support for an affirmative response to a question in the Questionnaire may require preapproval by IMSA in certain situations, as noted in the Handbook. It will be necessary for the practitioner to evaluate whether an alternative indicator used by the entity supports an affirmative response to the question. The alternative indicators should be disclosed by the practitioner to IMSA in the basic independent accountant's report as an attached appendix, and an explanatory paragraph should be added to the standard independent accountant's report in paragraph .26. The following is an example of a paragraph that should be included in the examination report when alternative indicators are used by management. The paragraph should precede the opinion paragraph.

Management's assertion supporting an affirmative response to certain questions is supported by the use of alternative indicators, as that term is defined in the IMSA Handbook. The attached appendix to this report lists the questions and alternative indicators used by management.

.31 Negative Responses. IMSA will not grant membership applications to an entity whose application contains a "no" response to any question. In circumstances where no report will be issued to IMSA, management may request the practitioner to report findings to management or the board of dir-

ectors. In this situation, the practitioner and management should agree on the means and format of such communication and document this understanding in writing.

.32 Working Papers. The practitioner should prepare and maintain working papers in connection with an engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner's needs on the engagement to which they apply. Although it is not possible to specify the form or content of the working papers that a practitioner should prepare in connection with an assessment because circumstances vary in individual engagements, the practitioner's working papers ordinarily should indicate that—

- a. The work was adequately planned and supervised.
- b. Evidential matter (SSAE No. 1 [AT sec. 100.36–39]) was obtained to provide a reasonable basis for the conclusion that the policies and procedures underlying the affirmative responses contained in the Questionnaire are in place.

In its required training, IMSA has advised IMSA-approved independent assessors to appreciate the sensitivity of insurers to litigation risks and the production of documents that litigation typically requires. IMSA has reminded assessors and insurers alike that the self-assessment process is designed to demonstrate compliance currently with IMSA assessment criteria and that reports will not be accepted by IMSA unless all questions are answered in the affirmative. Accordingly, IMSA has stated its belief that IMSA-approved assessors will have no need, at least for IMSA's purposes, to maintain documentation of noncompliance with the IMSA assessment criteria currently or in the past.

.33 Concern over access to the practitioner's working papers might cause some clients to inquire about working paper requirements. In situations where the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents, the practitioner may refer to the auditing Interpretation "The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.06–17) for guidance. See the attest Interpretation "Providing Access to or Photocopies of Working Papers to a Regulator" (AICPA, *Professional Standards*, vol. 1, AT sec. 9100.58) for guidance related to providing access to or photocopies of working papers to a regulator in connection with work performed on an attestation engagement.

.34 Management's Representations. The practitioner should obtain written representation from management—

- a. Acknowledging management's responsibility for the design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire are based and that the affirmative responses to the Questionnaire are based on such policies and procedures in place as of a specific point in time.
- b. Stating that management has adopted the Principles and Code, and has performed and made available to the practitioners all documentation related to a self-assessment of the policies and procedures in place as of the IMSA report date upon which the affirmative responses to the Questionnaire are based.

- c. Stating that management has disclosed to the practitioner all matters regarding the design, implementation, and monitoring of policies and procedures that could adversely affect the entity's ability to answer affirmatively the questions in the Questionnaire.
- d. Describing any related material fraud or other fraud or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which the responses to the Questionnaire were made.
- e. Stating whether there were, subsequent to the date of management's self-assessment (that is, the IMSA report date), any known changes or deficiencies in the design, implementation, and monitoring of the policies and procedures in place, including any personnel changes or other considerations of reference to the IMSA Questionnaire subject matter.
- f. Stating that management has disclosed any communication from regulatory agencies, internal auditors, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the IMSA report date (the date of management's assertion) and the date of the practitioner's report (the date of signature).
- g. Stating that management has disclosed to the practitioners, orally or in writing, information about past market conduct issues (for example, policyholder complaints or litigation) of relevance to the IMSA Questionnaire subject matter and the related corrective measures taken to support affirmative responses in those areas.

.35 Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to preclude an unqualified report suitable for submission to IMSA. Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

Effective Date

.36 This SOP is effective for independent assessments with IMSA report dates after January 31, 1998. Early application is permissible.

Appendix A

Assessment of Attestation Risk

A.1. The following are examples of considerations that may influence the nature, timing, and extent of a practitioner's testing procedures relating to an entity's assertion of its affirmative responses to the Questionnaire. The considerations may also affect a practitioner's decision to accept such an engagement. The examples are not intended to be a complete list.

Management Characteristics and Influence Over the Control Environment

- Management's attitude regarding internal control over sales and marketing practices, which may affect its ability to foster a more comprehensive and effective compliance program
- Management's financial support of the internal resources allocated to the development and maintenance of compliance with the IMSA program through adequate funding, resources, time, etc.
- Management's history of ensuring that sales personnel are qualified, trained, licensed, and supervised
- Management's history and systems for tracking complaint and replacement trends
- Management's ability to generate timely, complete, and accurate information on issues of regulatory concern regarding sales and marketing practices
- The entity's relationship with its current independent assessor, regulatory authorities, or both (The practitioner should gain an understanding of the circumstances surrounding the disengagement of predecessor independent assessors, any issues identified in prior self-assessments or independent assessments, and consider making inquiries of predecessor assessors.)
- Consistent application of policies and procedures across product lines and distribution channels (If the entity did not address each distribution channel, product line, or both because it deemed certain ones to be immaterial in terms of premiums earned or in force, or because of low volume of production, the practitioner will need to use his or her professional judgment to assess whether the omitted product lines or distribution channels should have been considered in the entity's self-assessment and assess the impact on his or her ability to opine on management's assertions by exercising that judgment. The definition of the term *appropriate to its size* in the Handbook may also apply.)
- Whether the entity's approach to its self-assessment includes validation of the information it collected to support that policies and procedures are in place

Industry Conditions

- Changes in regulations or laws, such as those governing various products, sales methods and materials, agent compensation, and customer disclosure

- Publicity about sales and marketing practices and increased litigation to seek remedy
- Rapid changes in the industry, such as the introduction of new and complex product offerings or information technology
- The degree of competition or market saturation

Distribution, Sales Volume, and Products

- The diversity of distribution systems
- The relative volume of business for different products and distribution systems
- The length of time that products, distribution systems, or both have been available, used, or both
- Limitations of an entity's ability to assert control over producers
- Compliance training provided by management to its producers and employees involved in the sales process
- The complexity of product offerings
- The targeted markets for various products
- Whether the entity is applying for IMSA membership as a fleet of entities or as an individual entity (If the entity is applying for fleet membership, the independent assessor should plan the engagement to address whether the policies and procedures are in place at each company within the fleet, including newly acquired subsidiaries or affiliates in the fleet.)

Other Considerations

- Issues identified in prior self-assessments, independent assessments, and other services provided
- Findings from recent market conduct examinations conducted by regulatory authorities or internal auditors
- Policyholder concerns expressed through complaints or litigation
- Ratings received from rating agencies

Appendix B

Illustrative Procedures

B.1. Examples of illustrative procedures are provided in this appendix. The procedures are organized by the three aspects of each question. Many of these procedures can be used for more than one question. The illustrative procedures are intended to be used as a guide and are not to be considered all-inclusive. Because the objective and the types of policies and procedures for each question will differ according to the methods for establishing, maintaining, communicating, deploying, and monitoring as they differ by entity and for each question, no single methodology for testing can be suggested. Practitioners should use judgment to determine the procedures necessary to be performed to render an opinion. It will be more difficult to obtain objective evidence about some indicators than others. Accordingly, the practitioner should adjust the procedures selected for testing. A challenging aspect of the IMSA program is its application to various distribution channels, including independent producers, and how entities will satisfy questions relating to these various channels. This is because an entity's ability to enforce or encourage producers to use its policies and procedures varies by channel. The practitioner needs to clearly understand how an entity manages each significant distribution channel.

B.2. IMSA has identified three aspects of each question: approach, deployment, and monitoring. The aspects are defined in the glossary of the Handbook as follows:

Approach—A systematic method or means used by the entity to address the requirements of the Principles and Code, as queried by the specific question.

Deployment—Refers to the extent to which the entity's approach is actually being applied to the provisions of the Principles and Code.

Monitoring —To check routinely and systematically with a view to collecting certain specified categories of information, to investigate and resolve questions concerning anomalous or unexpected information, and to identify the need for or to make recommendations designed to reduce the probability of future anomalies. The Principles, Code, Accompanying Comments, and Questionnaire require that monitoring be performed to provide reasonable assurance that policies accurately reflect management's (or other applicable governing bodies') point of view, that procedures are designed to support those policies, and that procedures are appropriately executed.

Approach

B.3. The two components underlying the first aspect, *approach*, as defined by the Handbook are as follow:

- a. Does the insurer have in place policies and procedures that address the objective of the question?
- b. Is someone (an individual or a team) responsible for establishing, maintaining, communicating, deploying, and monitoring these policies and procedures?

B.4. The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *approach* aspect:

Examine Documentation

- Obtain and read written policies and procedures to obtain an understanding of—
 - a. The policies and procedures that are supposed to be in place and to which distribution systems, products, and markets those policies and procedures apply.
 - b. How the policies and procedures respond to the objective of the question.
 - c. Who (a person or department) is responsible for establishing, maintaining, communicating, deploying, and monitoring those policies and procedures.
- Examine job descriptions, titles, organization charts, and other communications for those identified as being responsible for the policies and procedures to support the assignment of those responsibilities.

Inquiry

- Through inquiry, obtain an understanding of—
 - a. How the policies and procedures are being used in practice.
 - b. Who is responsible for the policies and procedures being addressed.
 - c. The responsibilities of management and employees who oversee the policies and procedures.
 - d. Evidence that supports that the policies and procedures exist.
 - e. Evidence that policies and procedures have been in place for a sufficient period.
 - f. The distribution systems, products, and markets to which the policies and procedures apply.
 - g. How the policies and procedures respond to the selected indicator.

Deployment

B.5. The two components underlying the second aspect, *deployment*, as defined by the Handbook are as follow:

- a. Are the policies and procedures communicated?
- b. Does the insurer consistently use these policies and procedures?

B.6. The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *deployment* aspect:

Examine/Inspect Documentation

- Obtain and read internal documents—including memos, e-mail, handbooks, policy manuals, and contracts—to verify that communications have been made.
- Obtain and read written confirmation or other evidence that the intended audience of the policies and procedures has received and read the communication.

- Obtain independent confirmation that policies and procedures are being used.

Observation

- Observe that reference materials (internal or external) that may be required for personnel to adequately perform the policies and procedures are reasonably accessible.
- For a sample of items, perform a walkthrough of the policies and procedures deemed to be in place in the *approach* aspect to support that those policies and procedures are being consistently applied for distribution channels and product lines that use those policies and procedures. Determine that the policies and procedures have also been consistently applied for a sufficient time by including transactions for various dates in the sample of transactions for the walkthrough.

Inquiry

- Interview personnel who perform the activities described in the policies and procedures documents to support that policies and procedures have been communicated to them.

Monitoring

B.7. The two components underlying the third aspect, *monitoring*, as defined by the Handbook are as follow:

- a. Does the insurer routinely monitor the operation of these policies and procedures with a view toward achieving the intended result?
- b. Does the insurer act upon the information received?

B.8. The following are examples of procedures the practitioner and engagement team may employ to test the affirmative responses for the *monitoring* aspect:

Examine Documentation

- Obtain and examine documents prepared by entity personnel that provide the responsible party with appropriate monitoring tools (for example, management reports, trend analyses, and tracking logs).
- Examine monitoring tools to identify deviations from the expected results, provide analysis of these deviations, and demonstrate investigation has occurred.
- Examine documentation of the corrective actions taken in response to information received by the responsible parties.
- Examine monitoring documents subsequent to corrective action taking place to ascertain whether the incidence of an identified problem or complaint has decreased in frequency because of the corrective action.

Inquiry

- Interview the personnel responsible for preparing reports used as monitoring tools to determine that the appropriate information is being gathered in a reasonable manner.

- Interview the personnel responsible for acting on the information provided and identify the procedures in place to perform corrective actions.

Observation

- Examine monitoring reports to ascertain whether they are prepared and distributed on a regular basis to the responsible personnel.
- Perform a walkthrough for a selection of transactions in which the action described by the identified responsible party should have occurred and ascertain whether the procedure was put in place.
- Observe changes in policies and procedures or communications to entity personnel that have occurred because of the recurrence of an identified problem or complaint.

Appendix C

Sample Engagement Letter

The following is an illustration of a sample engagement letter that may be used for this type of engagement.

[CPA Firm Letterhead]

[Client's Name and Address]

Dear _____:

This will confirm our understanding of the arrangements for our examination of management's assertion that the affirmative responses of [name of client entity] to the Insurance Marketplace Standards Association ("IMSA") questionnaire (the "Questionnaire") relating to the Principles of Ethical Market Conduct and the Code of Ethical Market Conduct and Accompanying Comments for individually sold life and annuity products, are based on policies and procedures in place as of [the IMSA report date].

We will examine management's assertion that the affirmative responses to the Questionnaire are based on policies and procedures in place as of the IMSA report date for the purpose of expressing an opinion as to whether management's assertion is fairly stated, in all material respects, based upon the criteria set forth in the Principles of Ethical Market Conduct, Code of Ethical Market Conduct and Accompanying Comments, and Assessment Handbook. The Company is responsible for the design, implementation, and monitoring of the policies and procedures in place upon which the responses are based. Our responsibility is to express an opinion on management's assertion based on our examination.

We will conduct our examination in accordance with standards established by the American Institute of Certified Public Accountants and in accordance with the criteria set forth in the IMSA Assessment Handbook. Our examination will include obtaining an understanding of the policies and procedures in place upon which the affirmative responses to the Questionnaire are based and such other procedures as we consider necessary in the circumstances. Our examination will not be designed to evaluate whether the policies and procedures, upon which [the entity's] responses to the Questionnaire are based, operate effectively, nor will we evaluate whether [the entity] has complied with applicable laws or regulations. Accordingly, we will not express an opinion or any other form of assurance thereon.²

Working papers that are prepared in connection with this engagement are the property of the independent accountant. The working papers are prepared for the purpose of providing the principal support for the independent accountant's report.

At the completion of our work we expect to issue an examination report in a form acceptable to IMSA (example attached). If, however, we are not able to conclude that management's assertion that the affirmative responses to the

² The independent accountant may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter.

Questionnaire are based on policies and procedures in place as of the IMSA report date, we will so advise you. At that time we will discuss with you the form of communication, if any, that you desire for our findings. We will ask you to confirm your request in writing at that time. If no report is requested, we understand that our engagement will be terminated, our working papers will be destroyed (at your request), our professional fees will be payable in full, and our professional responsibilities to you will be complete. We will have no responsibility to report in writing at a later date. If you request written or oral communication of our findings, we will do so and our working papers will be retained in accordance with our firm's working paper retention policy. Our professional fees will be subject to adjustment. If you request that we delay issuance of our report until corrective action is taken that will result in affirmative answers to all questions, we will do so only at your written request. Our working papers will be retained in accordance with our firm's working paper retention policy. Again, our fees will be subject to adjustment. If we conclude that we are unable to issue an unqualified report, we reserve the right to bring the matter to the attention of an appropriate level of management or the board of directors.

The distribution of the independent accountant's report will be restricted to the board of directors and management of [*the entity*] and IMSA. [*The entity*] agrees that it will not use the CPA firm's name in advertising materials referring to [*the entity's*] membership in IMSA.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees.

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

We appreciate the opportunity to serve you.

Sincerely,

[Partner's Signature]

[Firm Name or Firm Representative]

Accepted and agreed to:

[Client Representative's Signature]

[Title]

[Date]

**Auditing Standards Board
(1997)**

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Section 11,350

Statement of Position 99-1 Guidance to Practitioners in Conducting and Reporting on an Agreed-Upon Procedures Engagement to Assist Management in Evaluating the Effectiveness of Its Corporate Compliance Program

May 21, 1999

NOTE

This Statement of Position presents the recommendations of the AICPA Health Care Pilot Task Force regarding the application of Statements on Standards for Attestation Engagements to agreed-upon procedures attestation engagements performed to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement entered into with the Office of Inspector General of the U.S. Department of Health and Human Services. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

Summary

This Statement of Position (SOP) provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the AICPA Statements on Standards for Attestation Engagements to assist a health care provider in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a Corporate Integrity Agreement (CIA) entered into with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. CIAs are specific to the entity involved; consequently, users of this SOP should be familiar with the specific requirements of the entity's CIA.

Introduction and Background

.01 Within the past several years, the health care industry has experienced a significant increase in the number and magnitude of allegations of fraud and abuse involving federal health care programs (for example, Medicare

and Medicaid) and private health care insurance. These allegations have triggered regulatory scrutiny, litigation, significant monetary settlements, and negative publicity related to—among other things—coding and billing practices, patient referrals, cost reporting, quality of care, and clinical practices. Typically, as part of the global resolution of these allegations, the entity enters into a Corporate Integrity Agreement (CIA) with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. Such agreements require that management annually report on its compliance with the terms of the CIA and that there be an assessment of the entity's compliance with the CIA. This assessment includes a billing analysis, which may be performed by an independent review organization (such as a practitioner or consultant) or the provider (if permitted by the OIG), and an agreed-upon procedures engagement.

.02 This SOP provides guidance to practitioners in conducting and reporting on an agreed-upon procedures engagement performed pursuant to the American Institute of Certified Public Accountants (AICPA) Statements on Standards for Attestation Engagements (SSAEs) to assist an entity in evaluating the effectiveness of its corporate compliance program consistent with the requirements of a CIA.¹ The terms of a CIA are unique to the entity; consequently, users of this SOP need to be familiar with the actual CIA and its requirements.

.03 This SOP applies to agreed-upon procedures engagements to assist in evaluating an entity's compliance for a specified period. Such engagements should follow the AICPA attestation standards, including SSAE No. 1, *Attestation Standards*; SSAE No. 3, *Compliance Attestation*; and SSAE No. 4, *Agreed-Upon Procedures Engagements*. The engagement should be conducted in accordance with standards established by the AICPA, including the criteria set forth in this SOP. However, this SOP is not intended to provide all the required criteria set forth in individual CIAs, nor all the applicable standards established by the AICPA. Additionally, the SOP contains some guidance that may be applied in evaluating an organization's corporate compliance program, even though the program was not imposed by a CIA.

Overview of a Typical Corporate Integrity Agreement

.04 A CIA is an agreement between a health care provider and the OIG in conjunction with a global settlement of a fraud investigation. Such an agreement typically seeks to establish a compliance program within the health care provider (for example, hospital, clinical lab, physician group) that will promote compliance with the requirements of Medicare, Medicaid, and all other federal health care programs.

.05 CIAs are case-specific. Their terms are tailored to address the organizational and operating deficiencies related to providing and billing for health care services that have been identified by the OIG, the entity, or others. Detailed

¹ The practitioner also might be engaged to assist in other areas beyond an agreed-upon procedures engagement such as providing consulting services in connection with evaluating the company's billing practices, policies, and procedures as required by the CIA or in implementing, assessing, and reporting on voluntarily adopted compliance programs. In addition, the practitioner may assist in preparing an entity's self-disclosure reports to federal health agencies related to billing errors and other compliance matters. Similarly, practitioners may be involved in an entity's preparation of government-required (but not CIA-imposed) compliance reporting (for example, contract requirements for Medicare part C) beyond an agreed-upon procedures engagement.

compliance requirements are imposed as a condition for continued participation in federal health care programs. A sample CIA, provided by the OIG and intended to identify potential requirements, is included in appendix A [paragraph .32], "Sample Corporate Integrity Agreement." Typical agreements cover five years and require the entity to address the following areas:

- Appointment of a compliance officer and establishment of a compliance committee
- Establishment of a code of conduct
- Establishment of policies and procedures regarding the compliance program
- Development of an information and education program as to CIA requirements, compliance program and code of conduct
- Annual assessment of billing policies, procedures, and practices
- Establishment of a confidential disclosure program
- Prohibition of employment of excluded or convicted persons
- Notification to OIG of investigation or legal proceedings
- Reporting of credible evidence of misconduct
- Notifications to OIG of new provider locations
- Provision of implementation and annual reports
- Proper notification and submission of required reports
- Granting of OIG access to documents and individuals to conduct assessments
- Documentation of record retention requirements
- Awareness of disclosure criteria
- Agreement to comply with certain default provisions, penalties, and remedies
- Review of rights as to dispute resolution
- Review of effective and binding agreement clauses

Conditions for Engagement Performance

.06 A practitioner may perform an agreed-upon procedures engagement related to management's compliance with a CIA if all of the conditions specified in SSAE No. 4 and SSAE No. 3 are met.

.07 As discussed more fully in the SSAEs noted in paragraph .06, management's assertions as to its compliance must be capable of evaluation against reasonable criteria that either have been established by a recognized body or are stated in or attached to the practitioner's report in a sufficiently clear and comprehensive manner. Generally, to avoid confusion, management's assertions, which are based on the specific terms of its CIA, should be attached to the practitioner's report. If the entity is not subject to a CIA, management may develop its assertions using the model CIA. A sample based on the model CIA, which is not meant to be all-inclusive, is included as appendix B [paragraph .33], "Sample Statement of Management's Assertions."

Establishing an Understanding With the Client

.08 The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter. Appendix C [paragraph .34], "Sample Engagement Letter," contains a sample engagement letter that may be used for this kind of engagement.

Users' Responsibilities

.09 Users typically would be the management of the health care provider and the OIG. Management is responsible for ensuring that the entity complies with the requirements of the CIA. That responsibility encompasses (a) identifying applicable compliance requirements, (b) establishing and maintaining internal control policies and procedures to provide reasonable assurance that the entity complies with those requirements, (c) evaluating and monitoring the entity's compliance, and (d) preparing reports that satisfy legal, regulatory, or contractual requirements. Management's evaluation may include documentation such as accounting or statistical data, policy manuals, accounting manuals, narrative memoranda, procedural write-ups, flowcharts, completed questionnaires, internal auditors' reports, and other special studies or analyses. The form and extent of documentation will vary depending on the nature of the compliance requirements and the size and complexity of the entity. Management may engage the practitioner to gather information to assist it in evaluating the entity's compliance. Regardless of the procedures performed by the practitioner, management must accept responsibility for its assertions and must not base such assertions solely on the practitioner's procedures.

.10 Specified users are responsible for the sufficiency (nature, timing, and extent) of the agreed-upon procedures because they best understand their own needs. The specified users assume the risk that such procedures might be insufficient for their purposes. In addition, the specified users assume the risk that they might misunderstand or otherwise inappropriately use findings properly reported by the practitioner.

Practitioner's Responsibilities

.11 The objective of the practitioner's agreed-upon procedures is to present specific findings to assist users in evaluating an entity's compliance with the requirements specified in the CIA. (See appendix D [paragraph .35], "Sample Procedures.")

.12 The practitioner's procedures generally may be as limited or extensive as the specified users desire, as long as the specified users agree upon the procedures performed or to be performed and take responsibility for the sufficiency of the agreed-upon procedures for their purposes.

.13 To satisfy the requirements that the practitioner and the specified users agree upon the procedures performed or to be performed and that the specified users take responsibility for the sufficiency of the agreed-upon procedures for their purposes, ordinarily the practitioner should communicate directly with and obtain affirmative acknowledgment from each of the specified users. For the purposes of these engagements, an effective way to obtain this agreement ordinarily is to distribute a draft of the report, detailing the procedures, that is expected to be issued to the OIG with a request for any comments it may have.

.14 To avoid possible misunderstandings, the practitioner should circulate the draft with a legend stating that these are the procedures expected to be performed, and unless informed otherwise, the practitioner assumes that there are no additional procedures that he or she is expected to perform. A legend such as the following might be used.

This draft is furnished solely for the purpose of indicating the form of report that we would expect to be able to furnish pursuant to the request by Management of [Provider] for our performance of limited procedures relating to [Provider's] compliance with the Corporate Integrity Agreement with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services. Based on our discussions with [Provider], it is our understanding that the procedures outlined in this draft report are those we are expected to follow. Unless informed otherwise within ninety (90) days of this transmittal, we shall assume that there are no additional procedures that we are expected to follow. The text of the definitive report will depend, of course, on the results of the procedures.

Involvement of a Specialist²

.15 The practitioner's education and experience enable him or her to be knowledgeable about business matters in general, but he or she is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation. In certain circumstances, it may be appropriate to involve a specialist to assist the practitioner in the performance of one or more procedures. The following are examples:

- An attorney might provide assistance concerning the application of laws, regulations, or rules to a client's situation.
- A medical specialist might provide assistance in understanding the characteristics of diagnosis codes documented in patient medical records.

.16 The practitioner and the specified users should agree to the involvement of a specialist in assisting a practitioner in the performance of an agreed-upon procedures engagement. This agreement may be reached when obtaining agreement on the procedures performed or to be performed and acknowledgment of responsibility for the sufficiency of the procedures, as discussed previously. The practitioner's report should describe the nature of the assistance provided by the specialist.

.17 A practitioner may agree to apply procedures to the report or work product of a specialist that does not constitute assistance by the specialist to the practitioner in an agreed-upon procedures engagement. For example, the practitioner may make reference to information contained in a report of a specialist in describing an agreed-upon procedure. However, it is inappropriate for the practitioner to agree to merely read the specialist's report solely to describe or repeat the findings, or to take responsibility for all or a portion of any procedures performed by a specialist or the specialist's work product.

Internal Auditors and Other Personnel³

.18 The agreed-upon procedures to be enumerated or referred to in the practitioner's report are to be performed entirely by the practitioner except as

² A *specialist* is a person (or firm) possessing special skill or knowledge in a particular field other than the attest function. As used herein, a specialist does not include a person employed by the practitioner's firm who participates in the attestation engagement.

³ SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 322), does not apply to agreed-upon procedures engagements.

discussed in paragraphs .15–.17 of this SOP. However, internal auditors or other personnel may prepare schedules, accumulate data, perform an internal assessment of management's compliance, or provide other information for the practitioner's use in performing the agreed-upon procedures.

.19 A practitioner may agree to perform procedures on information documented in the working papers of internal auditors. For example, the practitioner may agree to—

- Repeat all or some of the procedures.
 - Determine whether the internal auditors' working papers contain documentation of procedures performed and whether the findings documented in the working papers are presented in a report by the internal auditors.
- .20 However, it is inappropriate for the practitioner to—
- Agree to merely read the internal auditor's report solely to describe or repeat its findings.
 - Take responsibility for all or a portion of any procedures performed by internal auditors by reporting those findings as the practitioner's own.
 - Report in any manner that implies shared responsibility for the procedures with the internal auditors.

Planning the Engagement

.21 Planning an agreed-upon procedures engagement involves working with the users to develop an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners should have adequate technical training and proficiency in the attestation standards and have adequate knowledge in health care regulatory matters to enable them to sufficiently understand the events, transactions, and practices that, in their judgment, have a significant effect on the presentation of the assertions.

Working Papers

.22 The practitioner should prepare and maintain working papers in connection with an engagement under the attestation standards; such working papers should be appropriate to the circumstances and the practitioner's needs on the engagement to which they apply.

.23 Concern over access to the practitioner's working papers might cause some clients to inquire about working paper requirements. In situations where the practitioner is requested to not maintain copies of certain client documentation, or to not prepare and maintain documentation similar to client documents, the practitioner may refer to the Auditing Interpretation, "The Auditor's Consideration of the Completeness Assertion" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326.06–.17), for guidance. See the Attest Interpretation, "Providing Access to or Photocopies of Working Papers to a Regulator," for guidance related to providing access to or photocopies of working papers to a regulator in connection with work performed on an attestation engagement.

Management's Representations

.24 The practitioner should obtain written representation from management on various matters including the following:

- a. Acknowledging management's responsibility for complying with the CIA
- b. Acknowledging management's responsibility for establishing and maintaining effective internal control over compliance
- c. Stating that management has performed an evaluation of the entity's compliance with CIA-specified requirements
- d. Stating management's assertions about the entity's compliance with all aspects of the CIA, including the specific issues that gave rise to the CIA⁴
- e. Stating that management has disclosed to the practitioner all known noncompliance with the CIA
- f. Stating that management has made available all documentation relating to compliance with the CIA
- g. Stating management's interpretation of any compliance requirements that have varying interpretations
- h. Stating that management has disclosed any communication from regulatory agencies, internal auditors, legal counsel, and other parties concerning matters regarding the design, implementation, and monitoring of the policies and procedures in place, including communication received between the end of the reporting period and the date of the practitioner's report (the date of signature)
- i. Stating that management has disclosed any known noncompliance occurring subsequent to the end of the reporting period
- j. Describing any related material fraud or abuse, other fraud, abuse or illegal acts that, whether or not material, involve management or other employees who have a significant role in the entity's design, implementation, and monitoring of the policies and procedures in place upon which compliance is based
- k. Stating that management has disclosed to the practitioners, orally or in writing, information about past noncompliance issues covered in the settlement agreement that gave rise to the CIA and the related corrective measures taken to support compliance in those areas

Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the engagement sufficient to require withdrawal from the engagement.

⁴ Depending on the circumstances, representations in the following areas might be appropriate.

- Violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid antifraud and abuse statutes
- Compliance of third-party billings with applicable coding guidelines (for example, ICD-9-CM, CPT) and laws and regulations (including medical necessity, proper approvals, and proper rendering of care)
- Proper filing of all required Medicare, Medicaid, and similar reports under the applicable reimbursement rules and regulations (including nature of costs—allowable, patient-related, properly allocated, in accordance with applicable rules and regulations, properly adjusted to reflect prior audit adjustments) and adequacy of disclosures (including disputed costs)

Reporting Considerations

.25 A practitioner should present the results of applying agreed-upon procedures to the specific subject matter in the form of findings. The practitioner should not provide negative assurance about whether the assertion is fairly stated in accordance with established or stated criteria. For example, the practitioner should not include a statement that “nothing came to my attention that caused me to believe that the assertion is not fairly stated in accordance with (established or stated) criteria.”

.26 The practitioner should report all findings from the application of the agreed-upon procedures. The concept of materiality does not apply to findings to be reported in an agreed-upon procedures engagement unless the definition of materiality is agreed to by the specified users. Any agreed-upon materiality limits should be described in the practitioner’s report.

.27 The practitioner has no obligation to perform procedures beyond the agreed-upon procedures. However, if noncompliance related to management’s assertion comes to the practitioner’s attention by other means, such information ordinarily should be included in his or her report.

.28 The practitioner may become aware of noncompliance related to management’s assertion that occurs subsequent to the reporting period but before the date of the practitioner’s report. The practitioner should consider including information regarding such noncompliance in his or her report. However, the practitioner has no responsibility to perform procedures to detect such noncompliance other than obtaining management’s representation about noncompliance in the subsequent period.

.29 The practitioner should follow the reporting guidance in SSAE No. 4. A sample report is included in appendix E [paragraph .36], “Sample Report.”

.30 Evaluating compliance with certain requirements may require interpretation of the laws, regulations, rules, contracts, or other agreements that establish those requirements. In such situations, the practitioner should consider whether he or she is provided with the reasonable criteria required to evaluate an assertion under the third general attestation standard. If these interpretations are significant, the practitioner may include a paragraph stating the description and the source of interpretations made by the entity’s management. An example of such a paragraph, which should precede the procedures and findings paragraph(s), follows:

We have been informed that, under [*name of entity’s*] interpretation of [*identify the compliance requirement*], [*explain the nature and source of the relevant interpretation*].

.31 The date of completion of the agreed-upon procedures should be used as the date of the practitioner’s report.

Appendix A

Sample Corporate Integrity Agreement Between the Office of Inspector General of the Department of Health and Human Services and [Provider]

I. Preamble

[Provider] (“[Provider]”) hereby enters into this Corporate Integrity Agreement (“CIA”) with the Office of Inspector General (“OIG”) of the United States Department of Health and Human Services (“HHS”) to ensure compliance by its employees with the requirements of Medicare, Medicaid and all other Federal health care programs (as defined in 42 U.S.C. 1320a-7b(f)) (hereinafter collectively referred to as the “Federal health care programs”). [Provider’s] compliance with the terms and conditions in this CIA shall constitute an element of [Provider’s] present responsibility with regard to participation in the Federal health care programs. Contemporaneously with this CIA, [Provider] is entering into a Settlement Agreement with the United States, and this CIA is incorporated by reference into the Settlement Agreement.

II. Term of the CIA

The period of the compliance obligations assumed by [Provider] under this CIA shall be 5 years from the effective date of this CIA (unless otherwise specified). The effective date of this CIA will be the date on which the final signatory of this CIA executes this CIA (the “effective date”).*

III. Corporate Integrity Obligations

[Provider] shall establish a compliance program that includes the following elements:

A. Compliance Officer

Within ninety (90) days after the effective date of this CIA, [Provider] shall appoint an individual to serve as Compliance Officer, who shall be responsible for developing and implementing policies, procedures, and practices designed to ensure compliance with the requirements set forth in this CIA and with the requirements of the Federal health care programs. The Compliance Officer shall be a member of senior management of [Provider], shall make regular (at least quarterly) reports regarding compliance matters directly to the CEO and/or to the Board of Directors of [Provider] and shall be authorized to report to the Board of Directors at any time. The Compliance Officer shall be responsible for monitoring the day-to-day activities engaged in by [Provider] to further its compliance objectives as well as any reporting obligations created under this CIA. In the event a new Compliance Officer is appointed during the term of this CIA, [Provider] shall notify the OIG, in writing, within fifteen (15) days of such a change.

* Source: Office of the Inspector General of the United States Department of Health and Human Services.

[Provider] shall also appoint a Compliance Committee within ninety (90) days after the effective date of this CIA. The Compliance Committee shall, at a minimum, include the Compliance Officer and any other appropriate officers as necessary to meet the requirements of this CIA within the provider's corporate structure (e.g., senior executives of each major department, such as billing, clinical, human resources, audit, and operations). The Compliance Officer shall chair the Compliance Committee and the Committee shall support the Compliance Officer in fulfilling his/her responsibilities.

B. Written Standards

1. *Code of Conduct.* Within ninety (90) days of the effective date of this CIA, [Provider] shall establish a Code of Conduct. The Code of Conduct shall be distributed to all employees within ninety (90) days of the effective date of this CIA. [Provider] shall make the promotion of, and adherence to, the Code of Conduct an element in evaluating the performance of managers, supervisors, and all other employees. The Code of Conduct shall, at a minimum, set forth:
 - a. [Provider's] commitment to full compliance with all statutes, regulations, and guidelines applicable to Federal health care programs, including its commitment to prepare and submit accurate billings consistent with Federal health care program regulations and procedures or instructions otherwise communicated by the Health Care Financing Administration ("HCFA") (or other appropriate regulatory agencies) and/or its agents;
 - b. [Provider's] requirement that all of its employees shall be expected to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [Provider's] own policies and procedures (including the requirements of this CIA);
 - c. the requirement that all of [Provider's] employees shall be expected to report suspected violations of any statute, regulation, or guideline applicable to Federal health care programs or with [Provider's] own policies and procedures;
 - d. the possible consequences to both [Provider] and to any employee of failure to comply with all statutes, regulations, and guidelines applicable to Federal health care programs and with [Provider's] own policies and procedures or of failure to report such non-compliance; and
 - e. the right of all employees to use the confidential disclosure program, as well as [Provider's] commitment to confidentiality and non-retaliation with respect to disclosures.

Within ninety (90) days of the effective date of the CIA, each employee shall certify, in writing, that he or she has received, read, understands, and will abide by [Provider's] Code of Conduct. New employees shall receive the Code of Conduct and shall complete the required certification within two (2) weeks after the commencement of their employment or within ninety (90) days of the effective date of the CIA, whichever is later.

[Provider] will annually review the Code of Conduct and will make any necessary revisions. These revisions shall be distributed within

thirty (30) days of initiating such a change. Employees shall certify on an annual basis that they have received, read, understand and will abide by the Code of Conduct.

2. *Policies and Procedures.* Within ninety (90) days of the effective date of this CIA, [Provider] shall develop and initiate implementation of written Policies and Procedures regarding the operation of [Provider's] compliance program and its compliance with all federal and state health care statutes, regulations, and guidelines, including the requirements of the Federal health care programs. At a minimum, the Policies and Procedures shall specifically address *[insert language relevant to allegations in the case]*. In addition, the Policies and Procedures shall include disciplinary guidelines and methods for employees to make disclosures or otherwise report on compliance issues to [Provider] management through the Confidential Disclosure Program required by section III.E. [Provider] shall assess and update as necessary the Policies and Procedures at least annually and more frequently, as appropriate. A summary of the Policies and Procedures will be provided to OIG in the Implementation Report. The Policies and Procedures will be available to OIG upon request.

Within ninety (90) days of the effective date of the CIA, the relevant portions of the Policies and Procedures shall be distributed to all appropriate employees. Compliance staff or supervisors should be available to explain any and all policies and procedures.

C. Training and Education

1. *General Training.* Within ninety (90) days of the effective date of this CIA, [Provider] shall provide at least two (2) hours of training to each employee. This general training shall explain [Provider's]:
 - a. Corporate Integrity Agreement requirements;
 - b. Compliance Program (including the Policies and Procedures as they pertain to general compliance issues); and
 - c. Code of Conduct.

These training materials shall be made available to the OIG, upon request.

New employees shall receive the general training described above within thirty (30) days of the beginning of their employment or within ninety (90) days after the effective date of this CIA, whichever is later. Each year, every employee shall receive such general training on an annual basis.

2. *Specific Training.* Within ninety (90) days of the effective date of this CIA, each employee who is involved directly or indirectly in the delivery of patient care and/or in the preparation or submission of claims for reimbursement for such care (including, but not limited to, coding and billing) for any Federal health care programs shall receive at least *[insert number of training hours]* hours of training in addition to the general training required above. This training shall include a discussion of:
 - a. the submission of accurate bills for services rendered to Medicare and/or Medicaid patients;

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- b. policies, procedures and other requirements applicable to the documentation of medical records;
- c. the personal obligation of each individual involved in the billing process to ensure that such billings are accurate;
- d. applicable reimbursement rules and statutes;
- e. the legal sanctions for improper billings; and
- f. examples of proper and improper billing practices.

These training materials shall be made available to OIG, upon request. Persons providing the training must be knowledgeable about the subject area.

Affected new employees shall receive this training within thirty (30) days of the beginning of their employment or within ninety (90) days of the effective date of this CIA, whichever is later. If a new employee has any responsibility for the delivery of patient care, the preparation or submission of claims and/or the assignment of procedure codes prior to completing this specific training, a [Provider] employee who has completed the substantive training shall review all of the untrained person's work regarding the assignment of billing codes.

Each year, every employee shall receive such specific training on an annual basis.

3. *Certification.* Each employee shall certify, in writing, that he or she has attended the required training. The certification shall specify the type of training received and the date received. The Compliance Officer shall retain the certifications, along with specific course materials. These shall be made available to OIG upon request.

D. Review Procedures

[Provider] shall retain an entity, such as an accounting, auditing or consulting firm (hereinafter "Independent Review Organization"), to perform review procedures to assist [Provider] in assessing the adequacy of its billing and compliance practices pursuant to this CIA. This shall be an annual requirement and shall cover a twelve (12) month period. The Independent Review Organization must have expertise in the billing, coding, reporting and other requirements of the Federal health care programs from which [Provider] seeks reimbursement. The Independent Review Organization must be retained to conduct the assessment of the first year within ninety (90) days of the effective date of this CIA. For purposes of complying with this review procedures requirement, the OIG at its discretion, may permit the [Provider] to utilize internal auditors to perform the review(s). In such case, the [Provider] will engage the Independent Review Organization to verify the propriety of the internal auditors' methods and accuracy of their results. The [Provider] will request the Independent Review Organization to produce a report on its findings which report shall be included in the Annual Report to the OIG.

The Independent Review Organization (or the [Provider], if permitted by the OIG, as set forth above) will conduct two separate engagements. One will be an analysis of [Provider's] billing to the Federal health care programs to assist the [Provider] and OIG in determining compliance

with all applicable statutes, regulations, and directives/guidance (“billing engagement”). The second engagement will assist the [Provider] and OIG in determining whether [Provider] is in compliance with this CIA (“compliance engagement”).

1. **Billing Engagement.** The billing engagement shall consist of a review of a statistically valid sample of claims for the relevant period. The sample size shall be determined through the use of a probe sample.¹ At a minimum, the full sample must be within a ninety (90) percent confidence level and a precision of twenty-five (25) percent. The probe sample must contain at least thirty (30) sample units and cannot be used as part of the full sample. Both the probe sample and the sample must be selected through random numbers. [Provider] shall use OIG’s Office of Audit Services Statistical Sampling Software, also known as “RAT-STATS”, which is available through the Internet at www.hhs.gov/progorg/ratstat.html.

Each annual billing engagement analysis shall include the following components in its methodology:

- a. **Billing Engagement Objective:** Provide a statement stating clearly the objective intended to be achieved by the billing engagement and the procedure or combination of procedures that will be applied to achieve the objective.
- b. **Billing Engagement Population:** Identify the population, which is the group about which information is needed. Explain the methodology used to develop the population and provide the basis for this determination.
- c. **Sources of Data:** Provide a full description of the source of the information upon which the billing engagement conclusions will be based, including the legal or other standards applied, documents relied upon, payment data, and/or any contractual obligations.
- d. **Sampling Unit:** Define the sampling unit, which is any of the designated elements that comprise the population of interest.
- e. **Sampling Frame:** Identify the sampling frame, which is the totality of the sampling units from which the sample will be selected.

As part of the billing engagement:

- a. Inquire of management as to the procedures and controls affecting the billing process subject to the annual assessment as specified in the CIA. Document that aspect of the billing process (e.g., flow of documents, processing activities), and those controls that will be tested in the sample. The documentation may consist of flow charts, excerpts from policies and procedures manuals, control questionnaires, etc.
- b. Report the sample results, including the overall error rate and the nature of the errors found (e.g., no documentation, inadequate documentation, assignment of incorrect code).

¹ Probe sample is defined as a small, random preliminary sample.

- c. Document findings related to *[Provider's]* procedures to correct inaccurate billings and codings to the Federal health care programs and findings regarding the steps *[Provider]* is taking to bring its operations into compliance or to correct problems identified by the audit.
2. *Agreed-upon Procedures or Compliance Engagement.* An Independent Review Organization (or the *[Provider]*, if permitted by the OIG) shall also conduct an agreed-upon procedures or compliance engagement, which shall assist the users in determining whether *[Provider's]* program, policies, procedures, and operations comply with the terms of this CIA. This engagement shall include a section by section analysis of the requirements of this CIA.

A complete copy of the Independent Review Organization's billing and agreed-upon procedures or compliance engagement shall be included in each of *[Provider's]* Annual Reports to OIG.

3. *Disclosure of Overpayments and Material Deficiencies.* If, as a result of these engagements, *[Provider]* or the Independent Review Organization identifies any billing, coding or other policies, procedures and/or practices that result in an overpayment, *[Provider]* shall notify the payor (e.g., Medicare fiscal intermediary or carrier) within 30 days of discovering the deficiency or overpayment and take remedial steps within 60 days of discovery (or such additional time as may be agreed to by the payor) to correct the problem, including preventing the deficiency from recurring. The notice to the payor shall include:
- a. a statement that the refund is being made pursuant to this CIA;
 - b. a description of the complete circumstances surrounding the overpayment;
 - c. the methodology by which the overpayment was determined;
 - d. the amount of the overpayment;
 - e. any claim-specific information used to determine the overpayment (e.g., beneficiary health insurance number, claim number, service date, and payment date);
 - f. the cost reporting period; and
 - g. the provider identification number under which the repayment is being made.

If *[Provider]* determines an overpayment represents a material deficiency, contemporaneous with *[Provider's]* notification to the payor as provided above, *[Provider]* shall also notify OIG of:

- a. a complete description of the material deficiency;
- b. amount of overpayment due to the material deficiency;
- c. *[Provider's]* action(s) to correct and prevent such material deficiency from recurring;
- d. the payor's name, address, and contact person where the overpayment was sent;

- e. the date of the check and identification number (or electronic transaction number) on which the overpayment was repaid.

For purposes of this CIA, an “overpayment” shall mean the amount of money the provider has received in excess of the amount due and payable under the Federal health care programs’ statutes, regulations or program directives, including carrier and intermediary instructions.

For purposes of this CIA, a “material deficiency” shall mean anything that involves: (i) a substantial overpayment or improper payment relating to the Medicare and/or Medicaid programs; (ii) conduct or policies that clearly violate the Medicare and/or Medicaid statute, regulations or directives issued by HCFA and/or its agents; or (iii) serious quality of care implications for federal health care beneficiaries or recipients. A material deficiency may be the result of an isolated event or a series of occurrences.

4. *Verification/Validation.* In the event that the OIG determines that it is necessary to conduct an independent review to determine whether or the extent to which [Provider] is complying with its obligations under this CIA, [Provider] agrees to pay for the reasonable cost of any such review or engagement by the OIG or any of its designated agents.

E. Confidential Disclosure Program

Within ninety (90) days after the effective date of this CIA, [Provider] shall establish a Confidential Disclosure Program, which must include measures (e.g., a toll-free compliance telephone line) to enable employees, contractors, agents or other individuals to disclose, to the Compliance Officer or some other person who is not in the reporting individual’s chain of command, any identified issues or questions associated with [Provider’s] policies, practices or procedures with respect to the Federal health care program, believed by the individual to be inappropriate. [Provider] shall publicize the existence of the hotline (e.g., e-mail to employees or post hotline number in prominent common areas).

The Confidential Disclosure Program shall emphasize a non-retribution, non-retaliation policy, and shall include a reporting mechanism for anonymous, confidential communication. Upon receipt of a complaint, the Compliance Officer (or designee) shall gather the information in such a way as to elicit all relevant information from the individual reporting the alleged misconduct. The Compliance Officer (or designee) shall make a preliminary good faith inquiry into the allegations set forth in every disclosure to ensure that he or she has obtained all of the information necessary to determine whether a further review should be conducted. For any disclosure that is sufficiently specific so that it reasonably: (1) permits a determination of the appropriateness of the alleged improper practice, and (2) provides an opportunity for taking corrective action, [Provider] shall conduct an internal review of the allegations set forth in such a disclosure and ensure that proper follow-up is conducted.

The Compliance Officer shall maintain a confidential disclosure log, which shall include a record and summary of each allegation received, the status of the respective investigations, and any corrective action taken in response to the investigation.

F. Ineligible Persons

[Provider] shall not hire or engage as contractors any "Ineligible Person." For purposes of this CIA, an "Ineligible Person" shall be any individual or entity who: (i) is currently excluded, suspended, debarred or otherwise ineligible to participate in the Federal health care programs; or (ii) has been convicted of a criminal offense related to the provision of health care items or services and has not been reinstated in the Federal health care programs after a period of exclusion, suspension, debarment, or ineligibility.

Within ninety (90) days of the effective date of this CIA, [Provider] will review its list of current employees and contractors against the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at <http://www.arnet.gov/epl>) and the HHS/OIG Cumulative Sanction Report (available through the Internet at <http://www.dhhs.gov/progorg/oig>) to ensure that it is not currently employing or contracting with any Ineligible Person. Thereafter, [Provider] will review the list once semi-annually to ensure that no current employees or contractors are or have become Ineligible Persons.

To prevent hiring or contracting with any Ineligible Person, [Provider] shall screen all prospective employees and prospective contractors prior to engaging their services by (i) requiring applicants to disclose whether they are Ineligible Persons, and (ii) reviewing the General Services Administration's List of Parties Excluded from Federal Programs (available through the Internet at <http://www.arnet.gov/epl>) and the HHS/OIG Cumulative Sanction Report (available through the Internet at <http://www.dhhs.gov/progorg/oig>).

If [Provider] has notice that an employee or agent is charged with a criminal offense related to any Federal health care program, or is suspended or proposed for exclusion during his or her employment or contract with [Provider], within 10 days of receiving such notice [Provider] will remove such employee from responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs until the resolution of such criminal action, suspension, or proposed exclusion. If [Provider] has notice that an employee or agent has become an Ineligible Person, [Provider] will remove such person from responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs and shall remove such person from any position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by Federal health care programs or otherwise with Federal funds at least until such time as the person is reinstated into participation in the Federal health care programs.

G. Notification of Proceedings

Within thirty (30) days of discovery, [Provider] shall notify OIG, in writing, of any ongoing investigation or legal proceeding conducted or brought by a governmental entity or its agents involving an allegation that [Provider] has committed a crime or has engaged in fraudulent activities or any other knowing misconduct. This notification shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation or legal proceeding. [Provider] shall also provide written notice to OIG within

thirty (30) days of the resolution of the matter, and shall provide OIG with a description of the findings and/or results of the proceedings, if any.

H. Reporting

1. *Credible evidence of misconduct.* If [Provider] discovers credible evidence of misconduct from any source and, after reasonable inquiry, has reason to believe that the misconduct may violate criminal, civil, or administrative law concerning [Provider's] practices relating to the Federal health care programs, then [Provider] shall promptly report the probable violation of law to OIG. Defendants shall make this disclosure as soon as practicable, but, not later than thirty (30) days after becoming aware of the existence of the probable violation. The [Provider's] report to OIG shall include:
 - a. the findings concerning the probable violation, including the nature and extent of the probable violation;
 - b. [Provider's] actions to correct such probable violation; and
 - c. any further steps it plans to take to address such probable violation and prevent it from recurring.

To the extent the misconduct involves an overpayment, the report shall include the information listed in section III.D.3 regarding material deficiencies.

2. *Inappropriate Billing.* If [Provider] discovers inappropriate or incorrect billing through means other than the Independent Review Organization's engagement, the provider shall follow procedures in section III.D.3 regarding overpayments and material deficiencies.

IV. New Locations

In the event that [Provider] purchases or establishes new business units after the effective date of this CIA, [Provider] shall notify OIG of this fact within thirty (30) days of the date of purchase or establishment. This notification shall include the location of the new operation(s), phone number, fax number, Federal health care program provider number(s) (if any), and the corresponding payor(s) (contractor specific) that has issued each provider number. All employees at such locations shall be subject to the requirements in this CIA that apply to new employees (e.g., completing certifications and undergoing training).

V. Implementation and Annual Reports

A. Implementation Report

Within one hundred and twenty (120) days after the effective date of this CIA, [Provider] shall submit a written report to OIG summarizing the status of its implementation of the requirements of this CIA. This Implementation Report shall include:

1. the name, address, phone number and position description of the Compliance Officer required by section III.A;
2. the names and positions of the members of the Compliance Committee required by section III.A;
3. a copy of [Provider's] Code of Conduct required by section III.B.1;

4. the summary of the Policies and Procedures required by section III.B.2;
5. a description of the training programs required by section III.C including a description of the targeted audiences and a schedule of when the training sessions were held;
6. a certification by the Compliance Officer that:
 - a. the Policies and Procedures required by section III.B have been developed, are being implemented, and have been distributed to all pertinent employees;
 - b. all employees have completed the Code of Conduct certification required by section III.B.1; and;
 - c. all employees have completed the training and executed the certification required by section III.C;
7. a description of the confidential disclosure program required by section III.E;
8. the identity of the Independent Review Organization(s) and the proposed start and completion date of the first audit; and
9. a summary of personnel actions taken pursuant to section III.F.

B. Annual Reports

[*Provider*] shall submit to OIG an Annual Report with respect to the status and findings of [*Provider's*] compliance activities. The Annual Reports shall include:

1. any change in the identity or position description of the Compliance Officer and/or members of the Compliance Committee described in section III.A;
2. a certification by the Compliance Officer that:
 - a. all employees have completed the annual Code of Conduct certification required by section III.B.1; and
 - b. all employees have completed the training and executed the certification required by section III.C;
3. notification of any changes or amendments to the Policies and Procedures required by section III.B and the reasons for such changes (e.g., change in contractor policy);
4. a complete copy of the report prepared pursuant to the Independent Review Organization's billing and compliance engagement, including a copy of the methodology used;
5. [*Provider's*] response/corrective action plan to any issues raised by the Independent Review Organization;
6. a summary of material deficiencies reported throughout the course of the previous twelve (12) months pursuant to III.D.3 and III.H;
7. a report of the aggregate overpayments that have been returned to the Federal health care programs that were discovered as a direct or indirect result of implementing this CIA. Overpayment amounts should be broken down into the following categories: Medicare, Medicaid (report each applicable state separately) and other Federal health care programs;

8. a copy of the confidential disclosure log required by section III.E;
9. a description of any personnel action (other than hiring) taken by [Provider] as a result of the obligations in section III.F;
10. a summary describing any ongoing investigation or legal proceeding conducted or brought by a government entity involving an allegation that [Provider] has committed a crime or has engaged in fraudulent activities, which have been reported pursuant to section III.G. The statement shall include a description of the allegation, the identity of the investigating or prosecuting agency, and the status of such investigation, legal proceeding or requests for information;
11. a corrective action plan to address the probable violations of law identified in section III.H; and
12. a listing of all of the [Provider's] locations (including locations and mailing addresses), the corresponding name under which each location is doing business, the corresponding phone numbers and fax numbers, each location's Federal health care program provider identification number(s) and the payor (specific contractor) that issued each provider identification number.

The first Annual Report shall be received by the OIG no later than one year and thirty (30) days after the effective date of this CIA. Subsequent Annual Reports shall be submitted no later than the anniversary date of the due date of the first Annual Report.

C. Certifications

The Implementation Report and Annual Reports shall include a certification by the Compliance Officer under penalty of perjury, that: (1) [Provider] is in compliance with all of the requirements of this CIA, to the best of his or her knowledge; and (2) the Compliance Officer has reviewed the Report and has made reasonable inquiry regarding its content and believes that, upon such inquiry, the information is accurate and truthful.

VI. Notifications and Submission of Reports

Unless otherwise stated in writing subsequent to the effective date of this CIA, all notifications and reports required under this CIA shall be submitted to the entities listed below:

OIG:

Civil Recoveries Branch—Compliance Unit
Office of Counsel to the Inspector General
Office of Inspector General
U.S. Department of Health and Human Services
Cohen Building, Room 5527
330 Independence Avenue, SW
Washington, DC 20201
Phone 202-619-2078; Fax 202-205-0604

[Provider]:

[Address and Telephone number of Provider's Compliance Contact]

VII. OIG Inspection, Audit and Review Rights

In addition to any other rights OIG may have by statute, regulation, or contract, OIG or its duly authorized representative(s), may examine [Provider's] books, records, and other documents and supporting materials for

the purpose of verifying and evaluating: (a) [Provider's] compliance with the terms of this CIA; and (b) [Provider's] compliance with the requirements of the Federal health care programs in which it participates. The documentation described above shall be made available by [Provider] to OIG or its duly authorized representative(s) at all reasonable times for inspection, audit or reproduction. Furthermore, for purposes of this provision, OIG or its duly authorized representative(s) may interview any of [Provider's] employees who consent to be interviewed at the employee's place of business during normal business hours or at such other place and time as may be mutually agreed upon between the employee and OIG. [Provider] agrees to assist OIG in contacting and arranging interviews with such employees upon OIG's request. [Provider's] employees may elect to be interviewed with or without a representative of [Provider] present.

VIII. Document and Record Retention

[Provider] shall maintain for inspection all documents and records relating to reimbursement from the Federal health care programs or to compliance with this CIA one year longer than the term of this CIA (or longer if otherwise required by law).

IX. Disclosures

Subject to HHS's Freedom of Information Act ("FOIA") procedures, set forth in 45 C.F.R. Part 5, the OIG shall make a reasonable effort to notify [Provider] prior to any release by OIG of information submitted by [Provider] pursuant to its obligations under this CIA and identified upon submission by [Provider] as trade secrets, commercial or financial information and privileged and confidential under the FOIA rules. [Provider] shall refrain from identifying any information as trade secrets, commercial or financial information and privileged and confidential that does not meet the criteria for exemption from disclosure under FOIA.

X. Breach and Default Provisions

[Provider] is expected to fully and timely comply with all of the obligations herein throughout the term of this CIA or other time frames herein agreed to.

A. Stipulated Penalties for Failure to Comply with Certain Obligations

As a contractual remedy, [Provider] and OIG hereby agree that failure to comply with certain obligations set forth in this CIA may lead to the imposition of the following monetary penalties (hereinafter referred to as "Stipulated Penalties") in accordance with the following provisions.

1. A Stipulated Penalty of \$2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day, beginning 120 days after the effective date of this CIA and concluding at the end of the term of this CIA, [Provider] fails to have in place any of the following:
 - a. a Compliance Officer;
 - b. a Compliance Committee;
 - c. a written Code of Conduct;
 - d. written Policies and Procedures;
 - e. a training program; and
 - f. a Confidential Disclosure Program;

2. A Stipulated Penalty of \$2,500 (which shall begin to accrue on the day after the date the obligation became due) for each day [Provider] fails to meet any of the deadlines to submit the Implementation Report or the Annual Reports to the OIG.
3. A Stipulated Penalty of \$2,000 (which shall begin to accrue on the date the failure to comply began) for each day [Provider]:
 - a. hires or contracts with an Ineligible Person after that person has been listed by a federal agency as excluded, debarred, suspended or otherwise ineligible for participation in the Medicare, Medicaid or any other Federal health care program (as defined in 42 U.S.C. 1320a7b(f)). This Stipulated Penalty shall not be demanded for any time period if [Provider] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in section III.F) as to the status of the person;
 - b. employs or contracts with an Ineligible Person and that person: (i) has responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs or (ii) is in a position for which the person's salary or the items or services rendered, ordered, or prescribed by the person are paid in whole or in part, directly or indirectly, by the Federal health care programs or otherwise with Federal funds (this Stipulated Penalty shall not be demanded for any time period during which [Provider] can demonstrate that it did not discover the person's exclusion or other ineligibility after making a reasonable inquiry (as described in III.F) as to the status of the person);
 - c. employs or contracts with a person who: (i) has been charged with a criminal offense related to any Federal health care program, or (ii) is suspended or proposed for exclusion, and that person has responsibility for, or involvement with, [Provider's] business operations related to the Federal health care programs (this Stipulated Penalty shall not be demanded for any time period before 10 days after [Provider] received notice of the relevant matter or after the resolution of the matter).
4. A Stipulated Penalty of \$1,500 (which shall begin to accrue on the date the [Provider] fails to grant access) for each day [Provider] fails to grant access to the information or documentation as required in section V of this CIA.
5. A Stipulated Penalty of \$1,000 (which shall begin to accrue ten (10) days after the date that OIG provides notice to [Provider] of the failure to comply) for each day [Provider] fails to comply fully and adequately with any obligation of this CIA. In its notice to [Provider], the OIG shall state the specific grounds for its determination that the [Provider] has failed to comply fully and adequately with the CIA obligation(s) at issue.

B. Payment of Stipulated Penalties

1. *Demand Letter.* Upon a finding that [Provider] has failed to comply with any of the obligations described in section X.A and

determining that Stipulated Penalties are appropriate, OIG shall notify [Provider] by personal service or certified mail of (a) [Provider's] failure to comply; and (b) the OIG's exercise of its contractual right to demand payment of the Stipulated Penalties (this notification is hereinafter referred to as the "Demand Letter").

Within fifteen (15) days of the date of the Demand Letter, [Provider] shall either (a) cure the breach to the OIG's satisfaction and pay the applicable stipulated penalties, or (b) request a hearing before an HHS administrative law judge ("ALJ") to dispute the OIG's determination of noncompliance, pursuant to the agreed-upon provisions set forth below in section X.D. In the event [Provider] elects to request an ALJ hearing, the Stipulated Penalties shall continue to accrue until [Provider] cures, to the OIG's satisfaction, the alleged breach in dispute. Failure to respond to the Demand Letter in one of these two manners within the allowed time period shall be considered a material breach of this CIA and shall be grounds for exclusion under section X.C.

2. *Timely Written Requests for Extensions.* [Provider] may submit a timely written request for an extension of time to perform any act or file any notification or report required by this CIA. Notwithstanding any other provision in this section, if OIG grants the timely written request with respect to an act, notification, or report, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until one day after [Provider] fails to meet the revised deadline as agreed to by the OIG-approved extension. Notwithstanding any other provision in this section, if OIG denies such a timely written request, Stipulated Penalties for failure to perform the act or file the notification or report shall not begin to accrue until two (2) business days after [Provider] receives OIG's written denial of such request. A "timely written request" is defined as a request in writing received by OIG at least five (5) business days prior to the date by which any act is due to be performed or any notification or report is due to be filed.
3. *Form of Payment.* Payment of the Stipulated Penalties shall be made by certified or cashier's check, payable to "Secretary of the Department of Health and Human Services," and submitted to OIG at the address set forth in section VI.
4. *Independence from Material Breach Determination.* Except as otherwise noted, these provisions for payment of Stipulated Penalties shall not affect or otherwise set a standard for the OIG's determination that [Provider] has materially breached this CIA, which decision shall be made at the OIG's discretion and governed by the provisions in section X.C, below.

C. Exclusion for Material Breach of this CIA

1. *Notice of Material Breach and Intent to Exclude.* The parties agree that a material breach of this CIA by [Provider] constitutes an independent basis for [Provider's] exclusion from participation in the Federal health care programs (as defined in 42 U.S.C. 1320a7b(f)). Upon a determination by OIG that [Provider] has materially breached this CIA and that exclusion should be imposed, the OIG shall notify [Provider] by certified mail of (a) [Provider's] material breach; and (b) OIG's intent to exercise its

contractual right to impose exclusion (this notification is herein-after referred to as the “Notice of Material Breach and Intent to Exclude”).

2. *Opportunity to Cure.* [Provider] shall have thirty-five (35) days from the date of the Notice of Material Breach and Intent to Exclude Letter to demonstrate to the OIG’s satisfaction that:
 - a. [Provider] is in *full* compliance with this CIA;
 - b. the alleged material breach has been cured; or
 - c. the alleged material breach cannot be cured within the 35-day period, but that: (i) [Provider] has begun to take action to cure the material breach, (ii) [Provider] is pursuing such action with due diligence, and (iii) [Provider] has provided to OIG a reasonable timetable for curing the material breach.
3. *Exclusion Letter.* If at the conclusion of the thirty-five (35) day period, [Provider] fails to satisfy the requirements of section X.C.2, OIG may exclude [Provider] from participation in the Federal health care programs. OIG will notify [Provider] in writing of its determination to exclude [Provider] (this letter shall be referred to hereinafter as the “Exclusion Letter”). Subject to the Dispute Resolution provisions in section X.D, below, the exclusion shall go into effect thirty (30) days after the date of the Exclusion Letter. The exclusion shall have national effect and will also apply to all other federal procurement and non-procurement programs. If [Provider] is excluded under the provisions of this CIA, [Provider] may seek reinstatement pursuant to the provisions at 42 C.F.R. §§1001.3001–3004.
4. *Material Breach.* A material breach of this CIA means:
 - a. a failure by [Provider] to report a material deficiency, take corrective action and pay the appropriate refunds, as provided in section III.D;
 - b. repeated or flagrant violations of the obligations under this CIA, including, but not limited to, the obligations addressed in section X.A of this CIA;
 - c. a failure to respond to a Demand Letter concerning the payment of Stipulated Penalties in accordance with section X.B above; or
 - d. a failure to retain and use an Independent Review Organization for review purposes in accordance with section III.D.

D. Dispute Resolution

1. *Review Rights.* Upon the OIG’s delivery to [Provider] of its Demand Letter or of its Exclusion Letter, and as an agreed-upon contractual remedy for the resolution of disputes arising under the obligation of this CIA, [Provider] shall be afforded certain review rights comparable to the ones that are provided in 42 U.S.C. §§1320a7(f) and 42 C.F.R. §1005 as if they applied to the Stipulated Penalties or exclusion sought pursuant to this CIA. Specifically, the OIG’s determination to demand payment of Stipulated Penalties or to seek exclusion shall be subject to review

by an ALJ and, in the event of an appeal, the Departmental Appeals Board (“DAB”), in a manner consistent with the provisions in 42 C.F.R. §§1005.2–21. Notwithstanding the language in 42 C.F.R. §1005.2(c), the request for a hearing involving stipulated penalties shall be made within fifteen (15) days of the date of the Demand Letter and the request for a hearing involving exclusion shall be made within thirty (30) days of the date of the Exclusion Letter.

2. *Stipulated Penalties Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for stipulated penalties under this CIA shall be (a) whether [Provider] was in full and timely compliance with the obligations of this CIA for which the OIG demands payment; and (b) the period of noncompliance. [Provider] shall have the burden of proving its full and timely compliance and the steps taken to cure the noncompliance, if any. If the ALJ finds for the OIG with regard to a finding of a breach of this CIA and orders [Provider] to pay Stipulated Penalties, such Stipulated Penalties shall become due and payable twenty (20) days after the ALJ issues such a decision notwithstanding that [Provider] may request review of the ALJ decision by the DAB.
3. *Exclusion Review.* Notwithstanding any provision of Title 42 of the United States Code or Chapter 42 of the Code of Federal Regulations, the only issues in a proceeding for exclusion based on a material breach of this CIA shall be (a) whether [Provider] was in material breach of this CIA; (b) whether such breach was continuing on the date of the Exclusion Letter; and (c) the alleged material breach cannot be cured within the 35-day period, but that (i) [Provider] has begun to take action to cure the material breach, (ii) [Provider] is pursuing such action with due diligence, and (iii) [Provider] has provided to OIG a reasonable timetable for curing the material breach.

For purposes of the exclusion herein, exclusion shall take effect only after an ALJ decision that is favorable to the OIG. [Provider's] election of its contractual right to appeal to the DAB shall not abrogate the OIG's authority to exclude [Provider] upon the issuance of the ALJ's decision. If the ALJ sustains the determination of the OIG and determines that exclusion is authorized, such exclusion shall take effect twenty (20) days after the ALJ issues such a decision, notwithstanding that [Provider] may request review of the ALJ decision by the DAB.

4. *Finality of Decision.* The review by an ALJ or DAB provided for above shall not be considered to be an appeal right arising under any statutes or regulations. Consequently, the parties to this CIA agree that the DAB's decision (or the ALJ's decision if not appealed) shall be considered final for all purposes under this CIA and [Provider] agrees to waive any right it may have to appeal the decision administratively, judicially or otherwise seek review by any court or other adjudicative forum.

XI. Effective and Binding Agreement

Consistent with the provisions in the Settlement Agreement pursuant to which this CIA is entered, and into which this CIA is incorporated, [Provider] and OIG agree as follows:

- a. This CIA shall be binding on the successors, assigns and transferees of [Provider];
- b. This CIA shall become final and binding on the date the final signature is obtained on the CIA;
- c. Any modifications to this CIA shall be made with the prior written consent of the parties to this CIA; and
- d. The undersigned [Provider] signatories represent and warrant that they are authorized to execute this CIA. The undersigned OIG signatory represents that he is signing this CIA in his official capacity and that he is authorized to execute this CIA.

On Behalf of [Provider]

_____ [Date]

_____ [Date]

_____ [Date]

[Please identify all signatories]

**ON BEHALF OF THE OFFICE OF INSPECTOR GENERAL
OF THE DEPARTMENT OF HEALTH AND HUMAN SERVICES**

Lewis Moris [Date]

**Assistant Inspector General for Legal Affairs
Office of Inspector General
U.S. Department of Health and Human Services**

Appendix B

Sample Statement of Management's Assertions

[Date]

In connection with the Corporate Integrity Agreement (CIA) entered into with the Office of the Inspector General of the United States Department of Health and Human Services dated [date], we make the following assertions, which are true to the best of our knowledge and belief.

Governance

Within 90 days of the date of the CIA, we—

1. Established a Compliance Committee, which meets at least monthly and requires a quorum to meet.
2. Appointed to our Compliance Committee members who include at a minimum those individuals specified in the CIA.
3. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
4. Appointed a compliance officer, who reports directly to the individual specified in the CIA.

We appointed a compliance officer who—

1. Has sufficient staff and resources to carry out his or her responsibilities.
2. Actively participates in compliance training.
3. Has authority to conduct full and complete internal investigations without restriction.
4. Periodically revises the compliance program to meet changing circumstances and risks.

Billing Practices, Policies, and Procedures

Although no system of internal controls can provide absolute assurance that all bills comply in all respects with Medicare, Medicaid, and other federal health care program guidelines, we are not aware of any material weaknesses in our billing practices, policies, and procedures. Billings to third-party payors comply in all material respects with applicable coding principles and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse) and only reflect charges for goods and services that were medically necessary, properly approved by regulatory bodies (e.g., the Food and Drug Administration), if required and properly rendered. [Insert other assertions as necessary to address matters covered in the CIA.] Any Medicare, Medicaid, and other federal health program billing deficiencies that we identified have been properly reported to the applicable payor within 60 days of discovery of the deficiency.

Corporate Integrity Policy

1. Our policy was developed and implemented within [number] days of execution of the CIA.

2. The policy addresses the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures and guidelines or as otherwise communicated by Health Care Financing Administration (HCFA), its agents or any other agency engaged in the administration of the applicable federal health care program.
3. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [date].
4. Further details on the development and implementation of our policy were provided to the OIG in our letter dated [date].
5. Our policy was distributed to all employees, physicians and independent contractors involved in submitting or preparing requests for reimbursement.
6. We have prominently displayed a copy of our policy on the Company's premises.

Information and Education Program

As discussed more fully in our letter to the OIG dated [date], we conducted an Information and Education Program within [number] days of the CIA. The Information and Education Program requires that each officer, employee, agent and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [number] hours of training.

The training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations, applicable federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. The training material addresses those issues underlying our settlement with the OIG.

The experience of the trainers is consistent with the topics presented.

Confidential Disclosure Program

Our Confidential Disclosure Program—

1. Was established within [number] days of the CIA.
2. Enables any employee to disclose any practices or billing procedures relating to federal health care programs.
3. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.

4. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.
5. A detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures are summarized in Attachment [title] to our Annual Report.

Excluded Individuals or Entities

Company policy—

1. Prohibits the employment of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended or otherwise ineligible for participation in federal health care programs.
2. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
3. Provides for an annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

We are not aware of any individuals employed in contravention of the prohibitions in the CIA.

Record Retention

Our record retention policy is consistent with the requirements of the CIA.

Signed by:

[Chief Executive Officer]

[Chief Financial Officer]

[Corporate Compliance Officer]

Appendix C

Sample Engagement Letter

The following is an illustration of a sample engagement letter that may be used for this kind of engagement.

[CPA Firm Letterhead]

[Client's Name and Address]

Dear _____:

This will confirm our understanding of the arrangements for our performance of certain agreed-upon procedures in connection with management's compliance with the terms of the Corporate Integrity Agreement (CIA) with the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services (HHS) dated [date of CIA] for the period ending [date].

We will perform those procedures enumerated in the attachment to this letter. Our responsibility is to carry out these procedures and report our findings. We will conduct our engagement in accordance with standards established by the American Institute of Certified Public Accountants. Our planned procedures were agreed to by management and will be communicated to the OIG for its review and are based on the terms specified in the CIA. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, it is understood that we make no representation regarding the sufficiency of the procedures described in the attachment for the purpose for which this report has been requested or for any other purpose.

Management is responsible for the Company's compliance with all applicable laws, regulations, and contracts and agreements, including the CIA. Management also is responsible for the design, implementation, and monitoring of the policies and procedures upon which compliance is based.

Our engagement to perform agreed-upon procedures is substantially less in scope than an examination, the objective of which is the expression of an opinion on management's compliance with the CIA. Accordingly, we will not express such an opinion or any other form of assurance thereon.¹

¹ The independent accountant may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter. For example, the following might be included in the letter:

Our maximum liability relating to services rendered under this letter (regardless of form of action, whether in contract, negligence or otherwise) shall be limited to the charges paid to us for the portion of the services or work products giving rise to liability. We will not be liable for consequential or punitive damages (including lost profits or savings) even if aware of their possible existence.

You will indemnify us against any damage or expense that may result from any third-party claim relating to our services or any use by you of any work product, and you will reimburse us for all expenses (including counsel fees) as incurred by us in connection with any such claim, except to the extent such claim (i) is finally determined to have resulted from our gross negligence or willful misconduct or (ii) is covered by any of the preceding indemnities.

Working papers that are prepared in connection with this engagement are the property of the independent accountant. The working papers are prepared for the purpose of providing the principal support for the independent accountant's report. At the completion of our work, we expect to issue an agreed-upon procedures report in the attached form.

If, however, we are not able to complete all of the specified procedures, we will so advise you. At that time, we will discuss with you the form of communication, if any, that you desire for our findings. We will ask you to confirm your request in writing at that time. If you request that we delay issuance of our report until corrective action is taken that will result in compliance with all aspects of the CIA, we will do so only at your written request. Our working papers will be retained in accordance with our firm's working paper retention policy.

The distribution of the independent accountant's report will be restricted to the governing board and management of the Company and the OIG.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees.

We agree that to the extent required by law, we will allow the Comptroller General of the United States, HHS, and their duly authorized representatives to have access to this engagement letter and our documents and records to the extent necessary to verify the nature and amount of costs of the services provided to the Company, until the expiration of four years after we have concluded providing services to the Company that are performed pursuant to this Engagement Letter. In the event the Comptroller General, HHS, or their duly authorized representatives request such records, we agree to notify the Company of such request as soon as practicable.

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

If this letter correctly expresses your understanding of this engagement, please sign the enclosed copy where indicated and return it to us. We appreciate the opportunity to serve you.

Sincerely, _____
 [*Partner's Signature*]
 [*Firm Name or Firm Representative*]

Accepted and agreed to: _____
 [*Client Representative's Signature*]

[*Title*] _____

[*Date*] _____

Appendix D

Sample Procedures

Procedure**Findings****Governance**

1. We read the Company's corporate minutes and organization chart and ascertained that, within [number] days of the date of the Corporate Integrity Agreement (CIA), the Company—
 - a. Established a Compliance Committee, which is to meet meets at least monthly and requires a quorum to meet.
 - b. Appointed to its Compliance Committee members who include, at a minimum, those individuals specified in the CIA.
 - c. Delegated to the Compliance Committee the authority to implement and monitor the CIA, as evidenced by the organization chart or the Compliance Committee's charter.
 - d. Appointed a compliance officer who reports directly to the individual specified in the CIA.
2. We interviewed the compliance officer and were informed that, in his or her opinion, the Compliance Officer—
 - a. Has sufficient staff and resources to carry out his or her responsibilities.
 - b. Actively participates in compliance training.
 - c. Has the authority to conduct full and complete internal investigations without restriction.
 - d. Periodically revises the compliance program to meet changing circumstances and risks.
3. We read the OIG notification letter as specified in the CIA and noted that the appropriate official signed the letter, that it was addressed to the OIG, that it covered items (a) through (d) in Step 1, and that it was dated within [number of] days of the execution of the CIA.

Billing Practices, Policies, and Procedures

The practitioner might be engaged to provide consulting services in connection with the evaluation of the Company's billing practices, policies, and procedures. If so, generally no agreed-upon procedures would be performed relating to this area.

Alternatively, if the procedures relating to the Company's billing practices, policies, and procedures are performed by others such as the Company's internal audit staff, the practitioner performs Steps 4 through 9.

Procedure**Findings**

4. We read the compliance work plan and noted the following:
- a. The work plan's stated objectives include the determination that billings are accurate and complete, for services rendered that have been deemed by medical specialists as being necessary, and are submitted in accordance with federal program guidelines.
 - b. The work plan sampling methodology sets confidence levels consistent with those defined in the CIA.
 - c. The work plan identifies risk areas, as defined in the CIA (if applicable), and specifies testing procedures by risk area.
 - d. The work plan specifies that samples are taken in risk areas (if applicable) identified by the CIA.
 - e. The work plan includes testing procedures, which the practitioner should modify as required by the CIA, for the following risks areas (if applicable) identified in the CIA:
 - (1) Clinical documentation, as follows:
 - (i) No documentation of service
 - (ii) Insufficient documentation of service
 - (iii) Improper diagnosis or treatment plan giving rise to the provision of a medically unnecessary service or treatment
 - (iv) Service or treatment does not conform medically with the documented diagnosis or treatment plan
 - (v) Services incorrectly coded
 - (2) Billing and coding, as follows:
 - (i) Noncovered or unallowable service
 - (ii) Duplicate payment
 - (iii) DRG window error
 - (iv) Unbundling
 - (v) Utilization
 - (vi) Medicare credit balances

[*Note to Practitioner:* Modify the preceding list as required by the CIA.]
5. We selected [*quantity*] probe samples performed by the independent review organization for the following risk areas [*list risk areas tested*]. For the probe samples selected, we noted that the—
- a. Sample patient billing files were randomly selected.
 - b. Sample size reflected confidence levels specified in the CIA.
 - c. Sample plan describes how missing items (if any) would be treated.

Procedure**Findings**

- d. Patient billing files tested were pulled per the listing of random numbers and all patient billing files were accounted for in the working papers.
 - e. Work plans for the specific sample described the risk areas (if applicable) being tested and the testing approach/procedures.
 - f. Working papers noted the completion of each work plan step.
 - g. Working papers contained a summary of findings for the sample.
6. We reperformed the work plan steps [*list of specific steps performed*] for the sample patient billing files. The reperformance of work plan steps related to the medical review of the sample patient billing files was performed by the following individuals [*note the professional qualifications of individuals without listing names*]. Any exceptions between our findings and the Company's are summarized in the Attachment to this report.
7. We read the summary findings of all internal compliance reviews that the Company's Internal Audit department indicated it had performed for the Company and noted that all material billing deficiencies [*specify material threshold as defined by the Company*] noted therein were discussed in written communications addressed to the appropriate payor (for example, Medicare Part B carrier) and were dated within 60 days from the time the deficiency occurred.¹
8. We inquired of [*individual*] as to whether the Company took remedial steps within [*number of*] days (or such additional time as agreed to by the payor) to correct all material billing deficiencies noted in Step 7. We were informed that such remedial steps had been taken.
9. By reading applicable correspondence, we noted that any material billing deficiencies noted in Step 7 were communicated to the OIG, including specific findings relative to the deficiency, the Company's actions taken to correct the deficiency, and any further steps the Company plans to take to prevent any similar deficiencies from recurring.

¹ The CIA provides its own legal definition of a "material deficiency." Determination of whether a billing or other act meets this definition is normally beyond the auditor's professional competence and may have to await final determination by a court of law. Accordingly, to avoid confusion, a working definition different from that provided in the CIA (e.g., a specified dollar threshold) may be necessary.

Procedure**Findings****Corporate Integrity Policy**

10. We read the Company's Corporate Integrity Policy and noted the following.
 - a. The policy was developed and implemented within [number of] days of execution of the CIA.
 - b. The policy addressed the Company's commitment to preparation and submission of accurate billings consistent with the standards set forth in federal health care program statutes, regulations, procedures, and guidelines or as otherwise communicated by HCFA, its agents, or any other agency engaged in the administration of the applicable federal health care program.
 - c. The policy addressed the specific issues that gave rise to the settlement, as well as other risk areas identified by the OIG in published Fraud Alerts issued through [agency].
 - d. Correspondence addressed to the OIG covered the development and implementation of the policy.
 - e. Documentation indicating that the policy was distributed to all employees, physicians, and independent contractors involved in submitting or preparing requests for reimbursement.
 - f. The prominent display of a copy of the policy on the Company's premises.
11. We selected a sample of ten employees (involved in submitting and preparing requests for reimbursement) and examined written confirmation in the employee's personnel file indicating receipt of a copy of the Corporate Integrity Policy.

Information and Education Program

12. We read the Company's Information and Education Program and noted the following.
 - a. The Information and Education Program agenda was dated within [number of] days of execution of the CIA.
 - b. Correspondence covering the development and implementation of the Information and Education Program was addressed to the OIG.
 - c. The Information and Education Program requires that each officer, employee, agent, and contractor charged with administering federal health care programs (including, but not limited to billers, coders, nurses, physicians, medical records, hospital administration and other individuals directly involved in billing federal health care programs) receive at least [number of] hours of training.

Procedure**Findings**

13. We selected a sample of ten employees involved in billing, coding and/or charge capture and examined sign-in logs of the training classes and noted that each had signed indicating that they had received at least [*number of*] hours of training as specified in the Information and Education Program. We also reviewed tests and surveys completed by each of the ten trained employees noting evidence that they were completed.
14. We inquired as to the training of individuals not present during the regularly scheduled training programs and were informed that each such individual is trained either individually or in a separate make-up session. We inquired as to the names of individuals not initially present and selected one such individual and examined that individual's post-training test and survey for completion.
15. We read the course agenda and noted that the training provided to employees involved in billing, coding, and/or charge capture consisted of instructions on submitting accurate bills, the personal obligations of each individual to ensure billings are accurate, the nature of company-imposed disciplinary actions on individuals who violate company policies and/or laws and regulations applicable to federal health care program rules, legal sanctions against the company for submission of false or fraudulent information, and how to report potential abuses or fraud. We also noted that the training material addressed the following issues which gave rise to the settlement [*practitioner list*].
16. We inquired of the Corporate Compliance Officer as to the qualifications and experience of the trainers and were informed that, in the Corporate Compliance Officer's opinion, they were consistent with the topics presented.
17. We noted that the Company's draft Annual Report to the OIG dated [*date*] addresses certification of training.

Confidential Disclosure Program

18. We read documentation of the Company's Confidential Disclosure Program and noted that it—
 - a. Includes the printed effective date that was within [*number of*] days of execution of the CIA.
 - b. Consists of a confidential disclosure program enabling any employee to disclose any practices or billing procedures relating to federal health care programs.

Procedure**Findings**

- c. Provides a toll-free telephone line maintained by the Company, which Company representatives have indicated is maintained twenty-four hours a day, seven days a week, for the purpose of making any disclosures regarding compliance with the Company's Compliance Program, the obligations in the CIA, and Company's overall compliance with federal and state standards.
 - d. Includes policies requiring the review of any disclosures to permit a determination of the appropriateness of the billing practice alleged to be involved and any corrective action to be taken to ensure that proper follow-up is conducted.
19. We made five test calls to the toll-free telephone line (hotline) and noted the following.
- a. Each call was captured in the hotline logs and reported with all other incoming calls.
 - b. Anonymity is not discouraged.
20. We noted that the Company included in its draft Annual Report addressed to OIG dated [date] a detailed summary of the communications (including the number of disclosures by employees and the dates of such disclosures) concerning billing practices reported as, and found to be, inappropriate under the Confidential Disclosure Program, and the results of any internal review and the follow-up on such disclosures.
21. We observed the display of the Company's Confidential Disclosure Program, including notice of the availability of its hotline, on the Company's premises.

Excluded Individuals or Entities

22. We read the Company's written policy relating to dealing with excluded or convicted persons or entities and noted that the policy—
- a. Prohibits the hiring of or contracting with an individual or entity that is listed by a federal agency as convicted of abuse or excluded, suspended, or otherwise ineligible for participation in federal health care programs.
 - b. Includes a process to make an inquiry into the status of any potential employee or independent contractor.
 - c. Provides for a semi-annual review of the status of all existing employees and contractors to verify whether any individual had been suspended or excluded or charged with a criminal offense relating to the provision of federal health care services.

Procedure**Findings**

23. We selected a sample of ten employees hired over the course of the test period as defined in the CIA and examined support in the employee's personnel file documenting inquiries made into the status of the employee, including documentation of comparison to the *[source specified in the CIA]*.
24. We performed the following procedures related to the Company's semi-annual review of employee status.
 - a. Read documentation of the semi-annual review as evidence that a review was performed.
 - b. Selected and reviewed the lesser of ten or all exceptions and determined that such employees were removed from responsibility for or involvement with Provider business operations related to the Federal health care programs.
 - c. Examined a notification letter addressed to the OIG and dated within 30 days of the employee's removal from employment.
 - d. Inquired of *[officer]* as to whether he or she was aware of any individuals employed in contravention of the prohibitions in the CIA. If so, we further noted that *[indicate specific procedures]* to confirm that such situation was cured within 30 days by *[indicate how situation was cured]*.

Annual Report

25. We read the Company's draft Annual Report dated *[date]* and determined that it included the following items, to be modified as appropriate, by the practitioner:
 - a. Compliance Program Charter and organization chart
 - b. Amendments to policies
 - c. Detailed descriptions of reviews and audits
 - d. Summary of hotline communications
 - e. Summary of annual review of employees
 - f. Cross-referencing to items noted in the CIA

Record Retention

26. We read the Company's record retention policy and noted that it was consistent with the requirements as outlined in the CIA.

Appendix E

Sample Report

Independent Accountant's Report

[Date]

[Sample Health Care Provider]

Office of Inspector General of the U.S. Department of Health and Human Services

We have performed the procedures enumerated in the Attachment, which were agreed to by Sample Health Care Provider (Company) and the Office of Inspector General (OIG) of the U.S. Department of Health and Human Services, solely to assist the users in evaluating management's assertion about [name of entity's] compliance with the Corporate Integrity Agreement (CIA) with the OIG dated [date of CIA] for the [period] ending [date], which is included as Attachment A to this report. This agreed-upon procedures engagement was performed in accordance with standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of the specified users of the report. Consequently, we make no representation regarding the sufficiency of the procedures described in Attachment B either for the purpose for which this report has been requested or for any other purpose.

We were not engaged to and did not perform an examination, the objective of which would be the expression of an opinion on management's compliance with the CIA. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the Compliance Committee and management of the Company and the OIG, and is not intended to be and should not be used by anyone other than those specified parties.

[Include as Attachments the CIA and the summary that enumerates procedures and findings.]

[Signature]

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Section 11,360

Statement of Position 00-1 Auditing Health Care Third-Party Revenues and Related Receivables

March 10, 2000

NOTE

This Statement of Position presents the recommendations of the AICPA Health Care Third-Party Revenue Recognition Task Force with regard to auditing financial statement assertions about third-party revenues and related receivables of health care entities. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations in this Statement of Position.

Summary

This Statement of Position (SOP) provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters to consider in testing third-party revenues and related receivables, and provides guidance regarding the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties.

Introduction and Background

.01 Most health care providers participate in payment programs that pay less than full charges for services rendered. For example, some cost-based programs retrospectively determine the final amounts reimbursable for services rendered to their beneficiaries based on allowable costs. With increasing frequency, even non-cost-based programs (such as the Medicare Prospective Payment System) have become subject to retrospective adjustments (for example, billing denials and coding changes). Often, such adjustments are not known for a considerable period of time after the related services were rendered.

.02 The lengthy period of time between rendering services and reaching final settlement, compounded further by the complexities and ambiguities of reimbursement regulations, makes it difficult to estimate the net patient service revenue associated with these programs. This situation has been compounded due to the frequency of changes in federal program guidelines.

.03 The AICPA Audit and Accounting Guide *Health Care Organizations* (the Guide) requires that patient revenues be reported net of provisions for

contractual and other adjustments (paragraph 10.20). As a result, patient receivables, including amounts due from third-party payors, are also reported net of expected contractual and other adjustments. However, amounts ultimately realizable will not be known until some future date, which may be several years after the period in which the services were rendered.

.04 This SOP provides guidance to auditors regarding uncertainties inherent in health care third-party revenue recognition. It discusses auditing matters to consider in testing third-party revenue and related receivables, including the effects of settlements (both cost-based and non-cost-based third-party payment programs), and provides guidance regarding the sufficiency of evidential matter and reporting on financial statements of health care entities exposed to material uncertainties.

Scope and Applicability

.05 This SOP applies to audits of health care organizations falling within the scope of the Guide. Its provisions are effective for audits of periods ending on or after June 30, 2000. Early application of the provisions of this SOP is permitted.

Third-Party Revenues and Related Receivables— Inherent Uncertainties

.06 Health care entities need to estimate amounts that ultimately will be realizable in order for revenues to be fairly stated in accordance with generally accepted accounting principles (GAAP). The basis for such estimates may range from relatively straightforward calculations using information that is readily available to highly complex judgments based on assumptions about future decisions.

.07 Entities doing business with governmental payors (for example, Medicare and Medicaid) are subject to risks unique to the government-contracting environment that are hard to anticipate and quantify and that may vary from entity to entity. For example—

- A health care entity's revenues may be subject to adjustment as a result of examination by government agencies or contractors. The audit process and the resolution of significant related matters (including disputes based on differing interpretations of the regulations) often are not finalized until several years after the services were rendered.
- Different fiscal intermediaries (entities that contract with the federal government to assist in the administration of the Medicare program) may interpret governmental regulations differently.
- Differing opinions on a patient's principal medical diagnosis, including the appropriate sequencing of codes used to submit claims for payment, can have a significant effect on the payment amount.¹

¹ Historically, the Health Care Financing Administration (HCFA) contracted with Peer Review Organizations (PROs) to validate the appropriateness of admissions and the clinical coding from which reimbursement was determined. Such reviews were typically performed within ninety days of the claim submission date. However, the government has modified its policies with respect to such reviews and now analyzes coding errors through other means, including in conjunction with investigations conducted by the Office of the Inspector General (OIG) of the U. S. Department of Health and Human Services.

- Otherwise valid claims may be determined to be nonallowable after the fact due to differing opinions on medical necessity.
- Claims for services rendered may be nonallowable if they are later determined to have been based on inappropriate referrals.²
- Governmental agencies may make changes in program interpretations, requirements, or “conditions of participation,” some of which may have implications for amounts previously estimated.

.08 Such factors often result in retrospective adjustments to interim payments. Reasonable estimates of such adjustments are central to the third-party revenue recognition process in health care, in order to avoid recognizing revenue that the provider will not ultimately realize. The delay between rendering services and reaching final settlement, as well as the complexities and ambiguities of billing and reimbursement regulations, makes it difficult to estimate net realizable third-party revenues.

Management’s Responsibilities

.09 Management is responsible for the fair presentation of its financial statements in conformity with GAAP. Management also is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, record, process, summarize, and report transactions (as well as events and conditions) consistent with management’s assertions embodied in the financial statements. Despite the inherent uncertainties, management is responsible for estimating the amounts recorded in the financial statements and making the required disclosures in accordance with GAAP, based on management’s analysis of existing conditions.

.10 Management’s assertions regarding proper valuation of its revenues and receivables are embodied in the financial statements. Management is responsible for assuring that revenues are not recognized until their realization is reasonably assured. As a result, management makes a reasonable estimate of amounts that ultimately will be realized, considering—among other things—adjustments associated with regulatory reviews, audits, billing reviews, investigations, or other proceedings. Estimates that are significant to management’s assertions about revenue include the provision for third-party payor contractual adjustments and allowances.

.11 Management also is responsible for preparing and certifying cost reports submitted to federal and state government agencies in support of claims for payment for services rendered to government program beneficiaries.

The Auditor’s Responsibilities

.12 The auditor’s responsibility is to express an opinion on the financial statements taken as a whole. In reaching this opinion, the auditor considers the evidence in support of recorded amounts. If amounts are not known with certainty, the auditor considers the reasonableness of management’s estimates in the present circumstances. The auditor also considers the fairness of the presentation and adequacy of the disclosures made by management.

² Effective January 1, 1995, the Limitation on Certain Physician Referrals law prohibited physicians from referring Medicare and Medicaid patients to health care organizations with which they had a financial relationship for the furnishing of designated health services. Implementing regulations have not yet been adopted as of the date of this publication.

.13 In planning the audit, the auditor considers current industry conditions, as well as specific matters affecting the entity.³ Among a number of things, the auditor's procedures typically include an analysis of historical results (for example, prior fiscal intermediary audit adjustments and comparisons with industry benchmarks and norms) that enable the auditor to better assess the risk of material misstatements in the current period. When there are heightened risks, the auditor performs more extensive tests covering the current period. Exhibit 5.1 of the Guide includes a number of examples of procedures that auditors may consider.

.14 With respect to auditing third-party revenues, in addition to the usual revenue recognition considerations, the auditor considers whether amounts ultimately realizable are or should be presently known or are uncertain because they are dependent on some other future, prospective actions or confirming events. For example, under a typical fee-for-service contract with a commercial payor, if the provider has performed a service for a covered individual, the revenue to which the provider is entitled should be determinable at the time the service is rendered. On the other hand, if the service was provided under a cost-based government contract, the revenue ultimately collectible may not be known until certain future events occur (for example, a cost report has been submitted and finalized after desk review or audit). In this case, management estimates the effect of such potential future adjustments.

.15 As stated previously, management is responsible for preparing the estimates contained in the financial statements. The auditor evaluates the adequacy of the evidence supporting those estimates, reviews the facts supporting management's judgments, and evaluates the judgments made based on conditions existing at the time of the audit. The fact that net revenues recorded at the time services are rendered differ materially from amounts that ultimately are realized does not necessarily mean the audit was not properly planned or carried out. Similarly, the fact that future events may differ materially from management's assumptions or estimates does not necessarily mean that management's estimates were not valid or the auditor did not follow generally accepted auditing standards (GAAS) as described in this SOP with respect to auditing estimates.

Evidential Matter

.16 The measurement of estimates is inherently uncertain and depends on the outcome of future events. Statement on Auditing Standards (SAS) No. 57, *Auditing Accounting Estimates* (AICPA, *Professional Standards*, vol. 1, AU sec. 342), and SAS No. 79, *Amendment to SAS No. 58, Reports on Audited Financial Statements* (AICPA, *Professional Standards*, vol. 1, AU sec. 508) provide guidance to the auditor when the valuation of revenues is uncertain, pending the outcome of future events. In the current health care environment, conclusive evidence concerning amounts ultimately realizable cannot be expected to exist at the time of the financial statement audit because the uncertainty associated with future program audits, administrative reviews, billing reviews, regulatory investigations, or other actions will not be resolved until sometime in the future.

.17 The fact that information related to the effects of future program audits, administrative reviews, regulatory investigations, or other actions does

³ Risk factors, including ones related to legislative and regulatory matters, are discussed annually in the AICPA Audit Risk Alert *Health Care Industry Developments*.

not exist does not lead to a conclusion that the evidential matter supporting management's assertions is not sufficient to support management's estimates. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is available or can reasonably be expected to be available in the circumstances. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the valuation of revenues and receivables, and their presentation and disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.18 If relevant evidential matter exists that the auditor needs and is unable to obtain, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. For example, if an entity has conducted an internal evaluation (for example, of coding or other billing matters) under attorney—client privilege and management and its legal counsel refuse to respond to the auditor's inquiries and the auditor determines the information is necessary, ordinarily the auditor qualifies his or her opinion for a scope limitation.

.19 The auditor considers the reasonableness of management's assumptions in light of the entity's historical experience and the auditor's knowledge of general industry conditions, because the accuracy of management's assumptions will not be known until future events occur. For certain matters, the best evidential matter available to the auditor (particularly as it relates to clinical and legal interpretations) may be the representations of management and its legal counsel, as well as information obtained through reviewing correspondence from regulatory agencies.

.20 Pursuant to SAS No. 85, *Management Representations* (AICPA, *Professional Standards*, vol. 1, AU sec. 333), the auditor should obtain written representations from management concerning the absence of 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. Examples of specific representations include the following:

- **Receivables**
 - Adequate consideration has been given to, and appropriate provision made for, estimated adjustments to revenue, such as for denied claims and changes to diagnosis-related group (DRG) assignments.
 - Recorded valuation allowances are necessary, appropriate, and properly supported.
 - All peer review organizations, fiscal intermediary, and third-party payor reports and information have been made available.
- **Cost reports filed with third parties**
 - All required Medicare, Medicaid, and similar reports have been properly filed.
 - Management is responsible for the accuracy and propriety of all cost reports filed.
 - All costs reflected on such reports are appropriate and allowable under applicable reimbursement rules and regulations and are patient-related and properly allocated to applicable payors.
 - The reimbursement methodologies and principles employed are in accordance with applicable rules and regulations.

- Adequate consideration has been given to, and appropriate provision made for, audit adjustments by intermediaries, third-party payors, or other regulatory agencies.
 - All items required to be disclosed, including disputed costs that are being claimed to establish a basis for a subsequent appeal, have been fully disclosed in the cost report.
 - Recorded third-party settlements include differences between filed (and to be filed) cost reports and calculated settlements, which are necessary based on historical experience or new or ambiguous regulations that may be subject to differing interpretations. While management believes the entity is entitled to all amounts claimed on the cost reports, management also believes the amounts of these differences are appropriate.
- Contingencies
 - There are no violations or possible violations of laws or regulations, such as those related to the Medicare and Medicaid anti-fraud and abuse statutes, including but not limited to the Medicare and Medicaid Anti-Kickback Statute, Limitations on Certain Physician Referrals (the Stark law), and the False Claims Act, in any jurisdiction, whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency other than those disclosed or accrued in the financial statements.
 - Billings to third-party payors comply in all material respects with applicable coding guidelines (for example, ICD-9-CM and CPT-4) and laws and regulations (including those dealing with Medicare and Medicaid antifraud and abuse), and billings reflect only charges for goods and services that were medically necessary; properly approved by regulatory bodies (for example, the Food and Drug Administration), if required; and properly rendered.
 - There have been no communications (oral or written) from regulatory agencies, governmental representatives, employees, or others concerning investigations or allegations of noncompliance with laws and regulations in any jurisdiction (including those related to the Medicare and Medicaid antifraud and abuse statutes), deficiencies in financial reporting practices, or other matters that could have a material adverse effect on the financial statements.

.21 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.

Potential Departures From GAAP Related to Estimates and Uncertainties

.22 In addition to examining the evidence in support of management's estimates, the auditor determines that there has not been a departure from GAAP with respect to the reporting of those estimates in the financial statements. Such departures generally fall into one of the following categories:

- Unreasonable accounting estimates
- Inappropriate accounting principles
- Inadequate disclosure

Therefore, in order to render an opinion, the auditor's responsibility is to evaluate the reasonableness of management's estimates based on present circumstances and to determine that estimates are reported in accordance with GAAP and adequately disclosed.

.23 As discussed in SAS No. 31, *Evidential Matter* (AICPA, *Professional Standards*, vol. 1, AU sec. 326), the auditor's objective is to obtain sufficient competent evidential matter to provide him or her with a reasonable basis for forming an opinion. As discussed previously, exhibit 5.1 of the Guide provides a number of sample procedures that the auditor might consider in auditing an entity's patient revenues and accounts receivable, including those derived from third-party payors. For example, the Guide notes that the auditor might "test the reasonableness of settlement amounts, including specific and unallocated reserves, in light of the payors involved, the nature of the payment mechanism, the risks associated with future audits, and other relevant factors."⁴

Unreasonable Accounting Estimates

.24 In evaluating the reasonableness of management's estimates, the auditor considers the basis for management's assumptions regarding the nature of future adjustments and management's calculations as to the effects of such adjustments.⁵ The auditor cannot determine with certainty whether such estimates are right or wrong, because the accuracy of management's assumptions cannot be confirmed until future events occur.

.25 Though difficult to predict, it is reasonable for the auditor to expect that management has made certain assumptions (either in detail or in the aggregate) in developing its estimates regarding conditions likely to result in adjustments. The auditor gathers evidence regarding the reasonableness of the estimates (for example, consistency with historical experience and basis of management's underlying assumptions). In evaluating reasonableness, the auditor should obtain an understanding of how management developed the estimate. Based on that understanding, the auditor should use one or a combination of the following approaches:

- a. Review and test the process used by management to develop the estimate.
- b. Develop an independent expectation of the estimate to corroborate the reasonableness of management's estimates.
- c. Review subsequent events or transactions occurring prior to completion of fieldwork (AU sec. 342.10).

.26 Since no one accounting estimate can be considered accurate with certainty, the auditor recognizes that a difference between an estimated amount best supported by the audit evidence and the estimated amount included in the financial statements may be reasonable, and such difference would not be considered to be a likely misstatement. However, if the auditor

⁴ See paragraphs .25–.28.

⁵ The lack of such analyses may call into question the reasonableness of recorded amounts.

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 in the range as a likely misstatement and aggregate it with other likely misstatements. The auditor also should consider whether the difference between estimates best supported by the audit evidence and the estimates included in the financial statements, which are individually reasonable, indicate a possible bias on the part of the entity's management. For example, if each accounting estimate included in the financial statements was individually reasonable, but the effect of the difference between each estimate and the estimate best supported by the audit evidence was to increase income, the auditor should reconsider the reasonableness of the estimates taken as a whole (SAS No. 47, *Audit Risk and Materiality in Conducting an Audit* [AICPA, *Professional Standards*, vol. 1, AU sec. 312.36]).

.27 The auditor recognizes that approaches and estimates will vary from entity to entity. Some entities with significant prior experience may attempt to quantify the effects of individual potential intermediary or other governmental (for example, the Office of Inspector General and the Department of Justice) or private payor adjustments, basing their estimates on very detailed calculations and assumptions regarding potential future adjustments. Some may prepare cost report⁶ analyses to estimate the effect of potential adjustments. Others may base their estimates on an analysis of potential adjustments in the aggregate, in light of the payors involved; the nature of the payment mechanism; the risks associated with future audits; and other relevant factors.

.28 Normally, the auditor considers the historical experience of the entity (for example, the aggregate amount of prior cost-report adjustments and previous regulatory settlements) as well as the risk of potential future adjustments. The fact that an entity currently is not subject to a governmental investigation does not mean that a recorded valuation allowance for potential billing adjustments is not warranted. Nor do these emerging industry trends necessarily indicate that an accrual for a specific entity is warranted.

.29 In evaluating valuation allowances, the auditor may consider the entity's historical experience and potential future adjustments in the aggregate. For example, assume that over the past few years after final cost report audits were completed, a hospital's adjustments averaged 3 percent to 5 percent of total filed reimbursable costs. Additionally, the hospital is subject to potential billing adjustments, including errors (for example, violations of the three-day window, discharge and transfer issues, and coding errors). Even though specific incidents are not known, it may be reasonable for the hospital to estimate and accrue a valuation allowance for such potential future retrospective adjustments, both cost-based and non-cost-based. Based on this and other information obtained, the auditor may conclude that a valuation allowance for the year under audit of 3 percent to 5 percent of reimbursable costs plus additional amounts for potential non-cost-based program billing errors is reasonable.

⁶ Medicare cost reimbursement is based on the application of highly complex technical rules, some of which are ambiguous and subject to different interpretations even among Medicare's fiscal intermediaries. It is not uncommon for fiscal intermediaries to reduce claims for reimbursement that were based on management's good faith interpretations of pertinent laws and regulations. Additionally, the Provider Reimbursement Review Board (PRRB) or the courts may be required to resolve controversies regarding the application of certain rules. To avoid recognizing revenues before their realization is reasonably assured, providers estimate the effects of such potential adjustments. This is occasionally done by preparing a cost report based on alternative assumptions to help estimate contractual allowances required by generally accepted accounting principles. The existence of reserves or a reserve cost report does not by itself mean that a cost report was incorrectly or fraudulently filed.

.30 Amounts that ultimately will be realized by an entity are dependent on a number of factors, many of which may be unknown at the time the estimate is first made. Further, even if two entities had exactly the same clinical and coding experience, amounts that each might realize could vary materially due to factors outside of their control (for example, differing application of payment rules by fiscal intermediaries, legal interpretations of courts, local enforcement initiatives, timeliness of reviews, and quality of documentation). As a result, because estimates are a matter of judgment and their ultimate accuracy depends on the outcome of future events, different entities in seemingly similar circumstances may develop materially different estimates. The auditor may conclude that both estimates are reasonable in light of the differing assumptions.

Inappropriate Accounting Principles

.31 The auditor also determines that estimates are presented in the financial statements in accordance with GAAP. If the auditor believes that the accounting principles have not been applied correctly, causing the financial statements to be materially misstated, the auditor expresses a qualified or adverse opinion.

.32 Valuation allowances are recorded so that revenues are not recognized until the revenues are realizable. Valuation allowances are not established based on the provisions of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

.33 The auditor should be alert for valuation allowances not associated with any particular program, issue, or time period (for example, cost-report year or year the service was rendered). Such a reserve may indicate measurement bias. The auditor also considers the possibility of bias resulting in distorted earnings trends over time (for example, building up specific or unallocated valuation allowances in profitable years and drawing them down in unprofitable years).

Inadequate Disclosure

.34 If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with GAAP, the auditor should express a qualified or adverse opinion. SOP 94-6, *Disclosure of Certain Significant Risks and Uncertainties* [section 10,640], provides guidance on the information that reporting entities should disclose regarding risks and uncertainties existing as of the date of the financial statements.

.35 In the health care environment, it is almost always at least reasonably possible that estimates regarding third-party payments could change in the near term as a result of one or more future confirming events (for example, regulatory actions reflecting local or national audit or enforcement initiatives). For most entities with significant third-party revenues, the effect of the change could be material to the financial statements. Where material exposure exists, the uncertainty regarding revenue realization is disclosed in the notes to the financial statements. Because representations from legal counsel are often key audit evidence in evaluating the reasonableness of management's estimates of potential future adjustments, the inability of an attorney to form an opinion on matters about which he or she has been consulted may be indicative of an uncertainty that should be specifically disclosed in the financial statements.

.36 Differences between original estimates and subsequent revisions might arise due to final settlements, ongoing audits and investigations, or passage of time in relation to the statute of limitations. The Guide (paragraph 5.07) requires that these differences be included in the statement of operations in the period in which the revisions are made and disclosed, if material. Such differences are not treated as prior period adjustments unless they meet the criteria for prior period adjustments as set forth in FASB Statement No. 16, *Prior Period Adjustments*.

.37 Disclosures such as the following may be appropriate:

General Hospital (the Hospital) is a (not-for-profit, for-profit, or governmental hospital or health care system) located in (City, State). The Hospital provides health care services primarily to residents of the region.

Net patient service revenue is reported at estimated net realizable amounts from patients, third-party payors, and others for services rendered and includes estimated retroactive revenue adjustments due to future audits, reviews, and investigations. Retroactive adjustments are considered in the recognition of revenue on an estimated basis in the period the related services are rendered, and such amounts are adjusted in future periods as adjustments become known or as years are no longer subject to such audits, reviews, and investigations.

Revenue from the Medicare and Medicaid programs accounted for approximately 40 percent and 10 percent, respectively, of the Hospital's net patient revenue for the year ended 1999. Laws and regulations governing the Medicare and Medicaid programs are extremely complex and subject to interpretation. As a result, there is at least a reasonable possibility that recorded estimates will change by a material amount in the near term. The 1999 net patient service revenue increased approximately \$10,000,000 due to removal of allowances previously estimated that are no longer necessary as a result of final settlements and years that are no longer subject to audits, reviews, and investigations. The 1998 net patient service revenue decreased approximately \$8,000,000 due to prior-year retroactive adjustments in excess of amounts previously estimated.

Appendix

Other Considerations Related to Government Investigations

In recent years, the federal government and many states have aggressively increased enforcement efforts under Medicare and Medicaid anti-fraud and abuse legislation. Broadening regulatory and legal interpretations have significantly increased the risk of penalties for providers; for example, broad interpretations of “false claims” laws are exposing ordinary billing mistakes to scrutiny and penalty consideration. In such circumstances, evaluating the adequacy of accruals for or disclosure of the potential effects of illegal acts in the financial statements of health care organizations is a matter that is likely to require a high level of professional judgment.

As previously discussed in this SOP, the far-reaching nature of alleged fraud and abuse violations creates an uncertainty with respect to the valuation of revenues, because future allegations of illegal acts could, if proven, result in a subsequent reduction of revenues. In addition, management makes provisions in the financial statements and disclosures for any contingent liabilities associated with fines and penalties due to violations of such laws. FASB Statement No. 5, *Accounting for Contingencies*, provides guidance in evaluating contingent liabilities, such as fines and penalties under applicable laws and regulations. Estimates of potential fines and penalties are not accrued unless their payment is probable and reasonably estimable.

The auditor’s expertise is in accounting and auditing matters rather than operational, clinical, or legal matters. Accordingly, the auditor’s procedures focus on areas that normally are subject to internal controls relevant to financial reporting. However, the further that potential illegal acts are removed from the events and transactions ordinarily reflected in the financial statements, the less likely the auditor is to become aware of the act, to recognize its possible illegality, and to evaluate the effect on the financial statements. For example, determining whether a service was medically necessary, obtained through a legally appropriate referral, properly performed (including using only approved devices, rendered in a quality manner), adequately supervised, accurately documented and classified, or rendered and billed by nonsanctioned individuals typically is not within the auditor’s professional expertise. As a result, an audit in accordance with generally accepted auditing standards (GAAS) is not designed to detect such matters.

Further, an audit conducted in accordance with GAAS does not include rendering an opinion or any form of assurance on an entity’s compliance with laws and regulations.¹ Nor does an audit under GAAS include providing any assurance on an entity’s billings or cost report. In fact, cost reports typically are not prepared and submitted until after the financial statement audit has been completed.

¹ Even when auditors undertake a special engagement designed to attest to compliance with certain provisions of laws, regulations, contracts, and grants (for example, an audit in accordance with OMB Circular A-133), the auditor’s procedures do not extend to testing compliance with laws and regulations related to Medicare and Medicaid fraud and abuse.

Certain audit procedures, although not specifically designed to detect illegal acts, may bring possible illegal acts to an auditor's attention. When a potentially illegal act is detected, the auditor's responsibilities are addressed in SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317). Disclosure of an illegal act to parties other than the client's senior management and its audit committee or board of directors is not ordinarily part of the auditor's responsibility, and such disclosure would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects the auditor's opinion on the financial statements.²

² Statement on Auditing Standards No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317.23) discusses circumstances in which a duty to notify parties outside the client of detected illegal acts may exist.

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Section 11,370**Statement of Position 01-3
Performing Agreed-Upon Procedures
Engagements That Address Internal Control
Over Derivative Transactions as Required by
the New York State Insurance Law**

June 15, 2001

NOTE

This Statement of Position represents the recommendations of the AICPA's Reporting on Internal Control Over Derivative Transactions at Insurance Entities Task Force regarding the application of Statements on Standards for Attestation Engagements to agreed-upon procedures engagements performed to comply with the requirements of Section 1410(b)(5) of the New York State Insurance Law, as amended (the Law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the Law, and Section 178.6(b) of Regulation No. 163. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be aware that they may have to justify departures from the recommendations in this Statement of Position if the quality of their work is questioned.

Introduction and Background

.01 The New York State Insurance Department (the Department) has issued regulations to implement the New York Derivative Law (the Law) which amends Article 14 of the State of New York Insurance Law, effective July 1, 1999. The Law establishes certain requirements for domestic life insurers, domestic property and casualty insurers, domestic reciprocal insurers, domestic mortgage guaranty insurers, domestic cooperative property and casualty insurance corporations, and domestic financial guaranty insurers. Foreign insurers engaging in derivative transactions and derivative instruments are subject to and required to comply with all of the provisions of the Law. However, a foreign insurer may enter into other derivative transactions provided the insurer meets certain conditions of its domestic state law. In this document, an insurer covered by the Law is referred to as an *insurance company*.

.02 The requirements of the Law include the following:

- Approval by the board of directors, or a similar body, of derivative transactions
- Submission of a derivative use plan (the DUP) to the Department

- Assessment by an independent certified public accountant (CPA) of the insurance company's internal control over derivative transactions.

.03 In addition to the Law, the Department also has established Regulation No. 163, "Derivative Transactions" (11 NYCRR 178) (the Regulation), which provides guidance in implementing the Law. Section 178.6(b) of Regulation No. 163 states the following.

As set forth in section 1410(b)(5) of the Insurance Law, an insurer engaging in derivative transactions shall be required to include, as part of the evaluation of accounting procedures and internal controls required to be filed pursuant to section 307 of the Insurance Law, a statement describing the assessment by the independent certified public accountant of the internal controls relative to derivative transactions. The purpose of this part of the evaluation is to assess the adequacy of the internal controls relative to the derivative transactions. Such an assessment shall be made whether or not the derivative transactions are material in relation to the insurer's financial statements and shall report all material deficiencies in internal control relative to derivative transactions, whether or not such deficiencies would lead to an otherwise "reportable condition," as that term is used in auditing standards adhered to by certified public accountants. The statement describing the assessment need not be set forth in a separate report.

.04 The Department has proposed that the Regulation be amended to provide that an assessment in the form of an agreed-upon procedures engagement or other attestation engagement, as those terms are used in standards adhered to by CPAs, may be used to meet the requirement for an assessment of internal control over derivative transactions. This proposed amendment to the Regulation has not been promulgated at the date of this Statement of Position (SOP). However, in a letter dated April 27, 2001, the Department stated the following:

This letter confirms that in determining compliance with Section 1410(b)(5) of the Insurance Law, the Department acknowledges that an agreed-upon procedures engagement, including an engagement performed using the procedures in the proposed SOP ("Performing Agreed-Upon Procedures Engagements that Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law"), can be used to satisfy the statutory requirement.

.05 The DUP was due to be filed by applicable insurance companies by January 1, 2000. The first independent CPA's report is due on June 1, 2001. The Law expires on June 30, 2003; however, the State of New York may extend the expiration date.

.06 As previously stated, the letter from the Department indicates that an agreed-upon procedures engagement or other attestation engagement may be used to satisfy the requirements of the Law. However, this SOP only describes an agreed-upon procedures engagement. It does not address any other attestation engagements that might be performed, such as an examination-level attestation engagement. For guidance on performing such other attestation engagements, see "Attest Engagements," in *Statement on Standards for Attestation Engagements (SSAE) No. 10, Attestation Standards: Revision and Codification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101).

Applicability

.07 This SOP was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address an insurance

company's internal control over derivative transactions to meet the requirements of the Law. Practitioners should note that the engagement described in this SOP is designed only to satisfy the requirements of the Law. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement.

.08 Although the Department has indicated that an agreed-upon procedures engagement pursuant to this SOP can be used to satisfy the requirements for an assessment of internal control over derivative transactions, the Department has not agreed to the sufficiency of the procedures included in this SOP for their purposes.

The Law

Definition of a Derivative

.09 Article 14 of the Law defines a derivative instrument as including caps, collars, floors, forwards, futures, options, swaps, swaptions, and warrants.

.10 The following definitions are included in the Law and are applicable when performing the agreed-upon procedures engagement described in this SOP.

Cap—An agreement obligating the seller to make payments to the buyer with each payment based on the amount by which a reference price or level or the performance or value of one or more underlying interests exceeds a predetermined number, sometimes called the strike rate or strike price.

Collar—An agreement to receive payments as the buyer of an option, cap, or floor and to make payments as the seller of a different option, cap, or floor.

Floor—An agreement obligating the seller to make payments to the buyer in which each payment is based on the amount by which a predetermined number, sometimes called the floor rate or price, exceeds a reference price, level, performance, or value of one or more underlying interests.

Forward—An agreement (other than a future) to make or take delivery in the future of one or more underlying interests, or effect a cash settlement, based on the actual or expected price, level, performance, or value of such underlying interests, but shall not mean or include spot transactions effected within customary settlement periods, when-issued purchases, or other similar cash market transactions.

Future—An agreement traded on a futures exchange, to make or take delivery of, or effect a cash settlement based on the actual or expected price, level, performance, or value of one or more underlying interests.

Option—An agreement giving the buyer the right to buy or receive (a *call option*), sell or deliver (a *put option*), enter into, extend or terminate, or effect a cash settlement based on the actual or expected price, spread, level, performance, or value of one or more underlying interests.

Swap—An agreement to exchange or to net payments at one or more times based on the actual or expected price, yield, level, performance, or value of one or more underlying interests.

Swaption—An option to purchase or sell a swap at a given price and time or at a series of prices and times. A swaption does not mean a swap with an embedded option.

Warrant—An instrument that gives the holder the right to purchase or sell the underlying interest at a given price and time or at a series of prices and times outlined in the warrant agreement.

.11 Article 14 of the Law permits an insurance company to enter into *replication transactions* provided that certain conditions set forth in the Law are met. A replication transaction is defined in the Law as follows.

A derivative transaction or combination of derivative transactions effected either separately or in conjunction with cash market investments included in the insurer's investment portfolio in order to replicate the investment characteristic of another authorized transaction, investment or instrument and/or operate as a substitute for cash market transactions. A derivative transaction entered into by the insurer as a hedging transaction or income generation transaction authorized pursuant to this section [of the Law] shall not be considered a replication transaction.

Derivative Use Plan

.12 An insurance company entering into derivative transactions must file a DUP with the Department. The DUP generally should include the following items:¹

- A certified copy of the authorization by the insurer's board of directors, or other similar body, to file the DUP, which should include authorization of derivative transactions and an assurance that individuals responsible for derivative transactions, processes, and controls have the necessary experience and knowledge
- A section on management oversight standards including a discussion of the following:
 - Limits on identified risks
 - Controls over the nature and amount of identified risks
 - Processes for identifying such risks
 - Processes for documenting, monitoring, and reporting risk exposure
 - Internal audit and review processes that ensure integrity of the overall risk management process
 - Quarterly reporting to the board of directors
 - The establishment of risk tolerance levels
 - Management's measurement and monitoring against those levels
- A section on internal control and reporting including a discussion of the following:
 - The existence of controls over the valuation and effectiveness of derivative instruments
 - Credit risk management
 - The adequacy of professional personnel
 - Technical expertise and systems
 - Management reporting
 - The review and legal enforceability of derivative contracts between parties

¹ Reference should be made to the Law and the Regulation for specific details and exact requirements.

- A section on documentation and reporting requirements which shall for each derivative transaction document the following:
 - The purpose of the transaction
 - The assets or liabilities to which the transaction relates
 - The specific derivative instrument used
 - For over-the-counter (OTC) transactions, the name of the counterparty and counterparty exposure amount
 - For exchange traded transactions, the name of the exchange and the name of the firm handling the trade
- Written guidelines to be followed in engaging in derivative transactions. The guidelines should include or address the following:
 - The type, maturity, and diversification of derivative instruments
 - The limitation on counterparty exposures, including limitations based on credit ratings
 - The limitations on the use of derivatives
 - Asset and liability management practices with respect to derivative transactions
 - The liquidity needs and the insurance company's capital and surplus as it relates to the DUP
 - The policy objectives of management specific enough to outline permissible derivative strategies
 - The relationship of the strategies to the insurer's operations
 - How the strategies relate to the insurer's risk
 - A requirement that management establish and execute management oversight standards as required by the Law
 - A requirement that management establish and execute internal control and reporting standards as required by the Law
 - A requirement that management establish and execute documentation and reporting standards as required by the Law
- Guidelines for the insurer's determination of acceptable levels of basis risk, credit risk, foreign currency risk, interest rate risk, market risk, operational risk, and option risk
- A requirement that the board of directors and senior management comply with risk oversight functions and adhere to laws, rules, regulations, prescribed practices, or ethical standards

Related Professional Standards

AT Section 201, "Agreed-Upon Procedures Engagements," Statement on Standards for Attestation Engagements No. 10

.13 Agreed-upon procedures engagements performed to meet the requirements of the Law are to be performed in accordance with AT section 201, *Agreed-Upon Procedures Engagements*, in SSAE No. 10. As described in AT section 201.03, an agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter. Not all of the provisions of AT section 201 are discussed herein. Rather, this SOP includes guidance to assist practitioners in the application of selected aspects of AT section 201.

.14 AT section 201.06 states, in part, that the practitioner may perform an agreed-upon procedures engagement provided that, “. . . (c) the practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner; and (d) the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes.”

.15 As previously stated, the letter from the Department states that an agreed-upon procedures engagement may be used to meet the requirement for an independent CPA's assessment of internal control over derivative transactions, and acknowledges the use of this SOP in such engagements. Accordingly, practitioners should not eliminate any of the procedures presented in appendix B, “Agreed-Upon Procedures for Testing Internal Control Over Derivative Transactions” [paragraph .37], of this SOP or reduce the extent of the tests. The Department or the insurance company may request that additional procedures be performed and the practitioner may agree to perform such procedures. In those circumstances, it would be expected that the additional procedures would be performed in the context of a separate agreed-upon procedures engagement.

.16 As previously noted, the Department has not agreed to the sufficiency of the procedures included in this SOP for their purposes. *Therefore, the Department should not be named as a specified party to the agreed-upon procedures report, and the use of a practitioner's agreed-upon procedures report, issued in accordance with this SOP, should be restricted to the board of directors and management of the insurance company.* Although the Department is not a specified party, footnote 15 of AT section 101, *Attest Engagements*, states the following, in part:

. . . a regulatory agency as part of its oversight responsibility for an entity may require access to restricted-use reports in which they are not named as a specified party.

Statement on Auditing Standards No. 92, Auditing Derivative Instruments, Hedging Activities, and Investments in Securities

.17 Statement on Auditing Standards (SAS) No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 332), provides guidance to auditors in planning and performing auditing procedures for financial statement assertions about derivative instruments, hedging activities, and investments in securities in a financial statement audit performed in accordance with generally accepted auditing standards. A practitioner performing the agreed-upon procedures engagement described in this SOP may find it helpful to consider the guidance in SAS No. 92 and the related audit guide of the same name supporting SAS No. 92. Specifically, the practitioner should consider AU sections 332.05 and 332.06 of SAS No. 92 which describe the need for special skill or knowledge to plan and perform the auditing procedures presented in SAS No. 92. That same skill and knowledge is needed to perform the procedures described in this SOP.

.18 The procedures in this SOP are not designed to meet the requirements of generally accepted auditing standards for an audit of the financial statements of an entity that engages in derivative transactions. In addition, performing the audit procedures described in SAS No. 92 would not meet the requirements of this SOP.

.19 In an audit of financial statements, the auditor may determine that he or she will not perform procedures related to derivative transactions because they are not material to the financial statements. There is no requirement to perform the procedures described in this SOP when performing an audit of financial statements. In contrast, the Law requires that an assessment of internal control be performed whether or not the derivative transactions are material to the insurer's financial statements. Accordingly, a decision not to perform procedures related to derivative transactions in an audit of financial statements, because of immateriality, would not alleviate the requirement to perform the agreed-upon procedures engagement described herein.

Procedures to Be Performed

.20 The agreed-upon procedures to be performed are directed toward tests of controls over derivative transactions that occurred during the period covered by the practitioner's report. Any projection of the practitioner's findings to the future is subject to the risk that because of change, the controls may no longer be in existence, suitably designed, or operating effectively. Also, the potential effectiveness of controls over derivative transactions is subject to inherent limitations and, accordingly, errors or fraud may occur and not be detected.

.21 The procedures to be performed in the agreed-upon procedures engagement described in this SOP are presented in appendix B [paragraph .37]. The procedures have been designed so that the findings resulting from the application of the procedures can be recorded in a tabular format. The findings for each procedure should be reported as *No Exception*, *Exception*, or *N/A* (not applicable). If a procedure is not applicable to a particular insurance company, the procedure should be marked *N/A* rather than deleted from the report.

.22 Section 1 of appendix B [paragraph .37] of this SOP is applicable to all insurance companies that enter into derivative transactions. Therefore, the procedures in section 1 are to be performed in all engagements performed in accordance with this SOP. Sections 2 through 10 of appendix B [paragraph .37] of this SOP each address a specific type of derivative. The procedures in those sections are to be performed only if the insurance company entered into derivative transactions of the type covered by the section. Sections that address types of derivatives not used by the insurance company should not be attached to the agreed-upon procedures report.

.23 If any portion of a procedure results in an exception, the findings for that entire procedure should be recorded as an exception and described in the section "Description of Exceptions If Any," at the end of each section. The practitioner should provide a brief factual explanation for each exception that will enable the specified parties to understand the nature of the findings resulting in the exception. If management informs the practitioner that the condition giving rise to the exception was corrected by the date of the practitioner's report, the practitioner's explanation of the exception may include that information; for example, "Management has advised us that the condition resulting in the exception was corrected on Month X, 20XX. We have performed no procedures with respect to management's assertion."

.24 A practitioner may perform significant portions of the agreed-upon procedures engagement before the end of the period covered by the report. If, during that time, the practitioner identifies conditions that result in an exception in one or more agreed-upon procedures, he or she should report the exception in the findings section of the agreed-upon procedures report, even if management corrects the condition prior to the end of the period.

.25 The Law requires the insurance company to provide the Department with a statement describing the independent CPA's assessment of the insurance company's internal control over derivative transactions. It also requires the insurance company to include a description of any remedial actions taken or proposed to be taken to correct any deficiencies identified by the independent CPA.

.26 AT section 201.40 states the following.

The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the subject matter (or written assertion related thereto) referred to in the practitioner's report, the practitioner should include this matter in his or her report. For example, if during the course of applying agreed-upon procedures regarding an entity's internal control, the practitioner becomes aware of a material weakness by means other than performance of the agreed-upon procedures, the practitioner should include this matter in his or her report.

.27 A practitioner has no obligation to perform procedures beyond the agreed-upon procedures included in appendix B [paragraph .37] of this SOP. However, if information indicating a weakness in internal control over derivative transactions comes to the practitioner's attention by other means, such information should be included in the practitioner's report. This would apply to conditions or events occurring during the subsequent-events period (subsequent to the period covered by the practitioner's report but prior to the date of the practitioner's report) that either contradict the findings in the report or that would have resulted in the reporting of an exception by the practitioner if that condition or event had existed during the period covered by the report. However, the practitioner has no responsibility to perform any procedure to detect such conditions or events.

Establishing an Understanding With the Client

.28 In accordance with AT section 201.10, the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement performed to meet the regulatory requirements of the Law. Such an understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. The practitioner should document the understanding in the working papers, preferably through a written communication with the client (an *engagement letter*). The communication should be addressed to the client. Matters that might be included in such an understanding are the following:

- A statement confirming that an agreed-upon procedures engagement is to be performed to meet the requirements of Section 1410(b)(5) of the Law
- A statement identifying the procedures to be performed as those set forth in this SOP
- A statement identifying the client as the specified party to the agreed-upon procedures report

- A statement acknowledging the client's responsibility for the sufficiency of the procedures in the SOP
- A statement acknowledging that the practitioner makes no representation regarding the sufficiency of the procedures in the SOP
- A statement describing the responsibilities of the practitioner, including but not limited to the responsibility to perform the agreed-upon procedures and to provide the client with a report, and the circumstances under which the practitioner may decline to issue a report
- A statement indicating that the engagement will be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement indicating that an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the internal control over derivative transactions, and that if an examination were performed, other matters might come to the practitioner's attention
- A statement indicating that the practitioner will not express an opinion or any other form of assurance
- A statement describing the client's responsibility to comply with the Law and the client's responsibility for the design and operation of effective internal control over derivative transactions
- A statement describing the client's responsibility for providing accurate and complete information to the practitioner
- A statement indicating that the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner
- A statement restricting the use of the report to the client
- A statement describing any arrangements to involve a specialist

Management Representations

.29 Although AT section 201 does not require a practitioner to obtain a representation letter from management in an agreed-upon procedures engagement, it is recommended that the practitioner obtain such a letter when performing the engagement described in this SOP. The representation letter generally should be signed by the appropriate members of management including the highest ranking officer responsible for internal control over derivative transactions. Management's refusal to furnish written representations that the practitioner has determined to be appropriate for the engagement constitutes a limitation on the performance of the engagement that requires either modification of the report or withdrawal from the engagement.

.30 The representations that a practitioner deems appropriate will depend on the specific nature of the engagement; however, the practitioner ordinarily would obtain the following representations from management:

- A statement acknowledging responsibility for establishing and maintaining effective internal control over derivative transactions
- A statement that there have been no errors or fraud that might indicate a weakness in the internal control over derivative transactions

- A statement that management has disclosed to the practitioner all significant deficiencies in the design or operation of the internal control over derivative transactions
- A statement that management has disclosed to the practitioner any communications from regulatory agencies, internal auditors, and other practitioners or consultants relating to the internal control over derivative transactions
- A statement that management has made available to the practitioner all information they believe is relevant to the internal control over derivative transactions
- A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- A statement that no events have occurred subsequent to the date as of which the procedures were applied that would require adjustment to or modification to responses to the agreed-upon procedures

.31 An illustrative representation letter is presented in appendix C, "Illustrative Management Representation Letter" [paragraph .38] of this SOP. For additional information regarding management's representations in an agreed-upon procedures engagement, see AT sections 201.37-.39.

Restriction on the Performance of Procedures

.32 As previously stated, a practitioner should not agree to do either of the following.

- a. Eliminate any of the procedures presented in appendix B [paragraph .37] of this SOP, unless a section is not applicable because the insurance company did not enter into derivative transactions addressed by the section.
- b. Reduce the extent of the tests in an applicable section.

.33 If circumstances impose restrictions on the performance of the agreed-upon procedures presented in appendix B [paragraph .37] of this SOP, the practitioner should describe the restriction(s) in his or her report or withdraw from the engagement.

Dating the Report

.34 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Effective Date

.35 This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that address internal control over derivative transactions required by the Law.

Appendix A

Illustrative Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report based on the guidance in AT section 201, *Agreed-Upon Procedures Engagements*, in Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 201).

Independent Accountant's Report
on Applying Agreed-Upon Procedures

To the Management of ABC Insurance Company:

We have performed the applicable procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP), 01-3, *Performing Agreed-Upon Procedures Engagements That Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*, which were agreed to by ABC Insurance Company, solely to assist you in complying with the requirements of Section 1410(b)(5) of the New York State Insurance Law, as amended (the Law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the Law, and Section 178.6(b) of Regulation No. 163 during the year ended December 31, 20XX. Management of ABC Insurance Company is responsible for maintaining effective internal control over derivative transactions. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of ABC Insurance Company. Consequently, we make no representation regarding the sufficiency of the procedures described in the attached appendix either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in the attached appendix.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on the internal control over derivative transactions of ABC Insurance Company for the year ended December 31, 20XX. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the management and Board of Directors of ABC Insurance Company and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

Appendix B

Agreed-Upon Procedures for Testing Internal Control Over Derivative Transactions

The following table lists the types of derivative transactions permitted by the New York Derivative Law (the Law). We inquired of management of the insurance company as to whether the insurance company used the type of derivative addressed by each section, and marked the column entitled "Is the Section Applicable?" either *Yes* or *No* based on management's response to the inquiry. For each type of derivative with a *Yes* response, we performed the procedures in the applicable section and attached the section to the report. For each type of derivative with a *No* response, we did not perform procedures nor did we attach the applicable section to the report. We compared the types of derivative reported by the insurance company in its "Schedule of Derivative Transactions" included in the Annual Statement with the types of derivatives listed in the following table and found that the types of derivatives included in the schedule were marked *Yes* in the table.

Attachments to the Report		
No.	Section of the Agreed-Upon Procedures Type of Derivative	Is the Section Applicable? Yes or No
1	All Derivative Types	Yes
2	Cap Contracts	_____
3	Collar Contracts	_____
4	Floor Contracts	_____
5	Forward Contracts	_____
6	Future Contracts	_____
7	Option Contracts	_____
8	Swap Contracts	_____
9	Swaption Contracts	_____
10	Warrant Contracts	_____

Section 1—All Derivative Types

Procedures

<i>Findings</i>		
<i>No</i>		
<u>Exception</u>	<u>Exception</u>	<u>N/A</u>

The following procedures were performed to test controls applicable to all derivative transactions. The procedures were applied to the internal control over derivative transactions in existence during the year ended December 31, 20XX.

Documentation of Controls, Policies, and Procedures

1. Read the insurance company's derivative use plan (DUP), amendments thereto, and its documentation of controls, policies, and procedures that describe internal control over derivative transactions and found that the DUP and the documentation of controls, policies, and procedures include a description of controls that address the following:
 - a. Systems or processes for the periodic valuation of derivative transactions including mechanisms for compensating for any lack of independence in valuing derivative positions (Valuation)
 - b. Systems or processes for determining whether a derivative instrument used for hedging or replication has been effective (Effectiveness)
 - c. Credit risk management systems or processes for over-the-counter (OTC) derivative transactions that measure credit risk exposure using the counterparty exposure amount and policies for the establishment of collateral arrangements with counterparties (Credit Risk Management)
 - d. Management assessment of the adequacy and technical expertise of personnel associated with derivative transactions and systems to implement and control investment practices involving derivatives (Professional Competence)
 - e. Systems or processes for regular reports to management, segregation of duties, and internal review procedures (Reporting)

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

Procedures

Findings

<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>

f. Procedures for conducting initial and ongoing legal reviews of derivative transactions including assessments of contract enforceability (Legal Reviews)

Nontransaction-Specific Procedures

2. Read the minutes of meetings of the board of directors and found an indication that the board of directors of the insurance company approved the DUP and any amendments thereto.

3. Inquired of management as to whether the DUP and any amendments thereto were approved by the New York State Insurance Department and was advised that the DUP and any amendments thereto were approved.

4. Read the minutes of meetings of the board of directors and found an indication that the board of directors of the insurance company approved the commitment of financial resources determined by management to be sufficient to accomplish the objectives of the insurance company's DUP.

This procedure does not provide an assessment of or assurance about the adequacy of the resources determined by management to be sufficient to accomplish the objectives of the DUP.

In performing the following procedures, the practitioner should be aware that management frequently will have designated and will have in place limits, controls, or procedures that are more restrictive than those approved for use in the DUP.

5. For the year ended December 31, 20XX, inquired of management and was advised that—

a. There was monitoring of derivative transactions by a control staff, such as internal audit or other internal review group, that is independent of derivatives trading activities.

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
b. There were procedures in place for derivative personnel to obtain, prior to exceeding limits prescribed by management, at least oral approval from members of senior management who are independent of derivatives trading activities.	_____	_____	_____
c. There were procedures in place for senior management to address excesses related to management-established limits and divergences from management-approved derivative strategies, and that such management has authority to grant exceptions to derivatives limits.	_____	_____	_____
d. There were procedures in place requiring that management be informed when limits prescribed in the DUP were exceeded and for management to approve corrective action(s) in such circumstances.	_____	_____	_____
e. There were procedures in place for the accurate transmittal of derivatives positions to the risk measurement systems when management had implemented risk management systems.	_____	_____	_____
f. There were procedures in place for the performance of appropriate reconciliations to ensure data integrity across the full range of derivatives, including any new or existing derivatives that may be monitored apart from the main processing networks.	_____	_____	_____
g. There were procedures in place for risk managers and senior management to define constraints on derivative activities to ensure compliance with the DUP and to justify excesses with respect to specified management limits.	_____	_____	_____
h. There were procedures in place for senior management, an independent group, or an individual that management designated to perform at least an annual assessment of the identified controls and financial results of the derivative activities to determine that controls were effectively implemented and that the insurance company's business objectives and strategies were achieved.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
i. There were procedures in place for a review of limits in the context of changes in strategy, risk tolerance of the insurance company, and market conditions.	_____	_____	_____

Reporting to the Board of Directors or Committee Thereof

The Law contains provisions regarding management oversight of derivative and replication transactions.

6. Read the minutes of the board of directors meetings or committees thereof and found an indication that the board of directors or committee thereof received, at least quarterly, a report regarding derivative and replication transactions.	_____	_____	_____
7. Read one quarterly report referred to in procedure 6 and found that the report contained—			
a. A list, or appropriate summaries, of the following:			
(1) Derivative transactions during the period	_____	_____	_____
(2) Derivative transactions outstanding at the end of the period	_____	_____	_____
(3) Unrealized gains or losses on open derivative positions	_____	_____	_____
(4) Derivative transactions closed during the period	_____	_____	_____
b. A summary of the performance of the derivatives in comparison to the objective of the derivative transactions	_____	_____	_____
c. An evaluation of the risks and benefits of the derivative transactions	_____	_____	_____
d. A summary of the amount, type, and performance of replication transactions	_____	_____	_____
8. If the report referred to in the preceding procedure was received, reviewed, and approved by a committee of the board of directors, read the minutes of the board of directors meeting and found an indication that a report of such committee was reviewed at the next board of directors meeting.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
9. Read the board of directors minutes and found an indication that the board of directors received a report during the year describing the level of knowledge and experience of individuals conducting, monitoring, controlling, and auditing derivative and replication transactions.	_____	_____	_____

Derivative and Replication Limitations

The Law contains limits on hedging and replication transactions. An insurance company may enter into hedging or replication transactions if, as a result of and after giving effect to the transaction, the derivative investments and replication investments do not exceed certain specified percentages of admitted assets. The following procedures were performed using one analysis per quarter prepared by the insurance company to monitor compliance with the limitations.

10. Obtained and read the insurance company's analysis used to test limitations on investments in derivatives and replication transactions and found that the amounts shown in the analysis indicated that—			
a. The aggregate statement value of options, swaptions, caps, floors, and warrants purchased was not in excess of seven and one-half percent of the insurance company's admitted assets, per the last annual statement.	_____	_____	_____
b. The aggregate statement value of options, swaptions, caps, and floors written was not in excess of three percent of admitted assets.	_____	_____	_____
c. The aggregate potential exposure of collars, swaps, forwards, and futures entered into and options, swaptions, caps, and floors written was not in excess of six and one-half percent of admitted assets.	_____	_____	_____
d. The aggregate statement value of all assets being replicated did not exceed ten percent of the insurance company's admitted assets.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
e. The extent of derivative transactions did not exceed the insurance company's internal limitations or that any excess had been specifically authorized by management.	_____	_____	_____
11. Inquired of the preparer of the analysis read in procedure 10 and was advised that the analysis excluded transactions entered into to hedge the currency risk of investments denominated in a currency other than United States dollars.	_____	_____	_____
12. Obtained and read the insurance company's analysis used to test limitations on counterparty exposure, as defined in section 178.3(e) of the Regulation, and found that the report indicated that—			
a. The counterparty exposure under one or more derivative transactions for any single counterparty, other than a "qualified counterparty," was not in excess of one percent of the insurance company's admitted assets.	_____	_____	_____
b. The counterparty exposure under one or more derivative transactions for all counterparties, other than qualified counterparties, was not in excess of three percent of the insurance company's admitted assets.	_____	_____	_____
13. If the insurance company required collateral arrangements with the counterparties, obtained and read the insurance company's analysis used to monitor the adequacy of the collateral held in accordance with the terms of the arrangement and found that the amount of the collateral held as shown on the analysis was equal to or in excess of the amount to be held.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>
_____	_____
_____	_____
_____	_____
_____	_____

Section 2—Cap Contracts

Procedures

<u>Findings</u>		
<u>No</u>	<u>Exception</u>	<u>N/A</u>

Performed the following procedures on selected cap contracts to test internal control over cap transactions. Selected five percent of each type of cap transaction (that is, purchases [premium disbursements], sales [premium receipts], and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.

Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into cap contracts.
2. For each cap selected for testing, read management's documentation describing the intended use of the cap and performed the following procedures, as applicable.

_____	_____	_____
_____	_____	_____

For caps used as a hedge—

3. Determined that the documentation described the following:
 - a. The risk hedged
 - b. How the hedge was consistent with the overall risk management strategy
 - c. How the cap was expected to be effective in offsetting the exposure
 - d. The approach in assessing the effectiveness of the hedge
4. Determined that the following items were documented:
 - a. The purpose(s) of the cap as a hedge

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
b. The terms of the cap, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the cap hedged	_____	_____	_____
d. Evidence that the cap continued to be an effective hedge	_____	_____	_____
e. Evidence that the cap was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____
If the cap was an exact offset to an outstanding cap—			
5. Read documentation indicating that the cap offset an outstanding cap previously purchased or sold by the insurance company and that the cap was an exact offset of the market risk of the cap being offset.	_____	_____	_____
For caps used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the cap was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach for assessing the effectiveness of the replication transaction	_____	_____	_____
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
<p>b. The terms of the cap, the name of the counterparty, and the counterparty exposure amount</p>	_____	_____	_____
<p>For all selected caps including those that are a part of a replication transaction—</p>			
<p>8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize cap transactions. Compared the name of the individual who authorized the cap transaction with the names on the list and found the name of the individual on the list.</p>	_____	_____	_____
<p>9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.</p>	_____	_____	_____
<p>10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the cap transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.</p>	_____	_____	_____
<p>11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.</p>	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade cap contracts. Compared the name of the individual who executed the purchase, sale, or closeout of the cap with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments relating to caps. Compared the name of the individual who approved any payment relating to the cap with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the cap with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the cap with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the purchase, sale, or closeout of the cap and found that the purchase, sale, or closeout was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade caps and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the cap contract, as stated on the deal ticket and confirmation, with the terms of the cap contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
19. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company determined that its accounting records for caps tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the cap agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the cap agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the cap agreement and found them to be in agreement.	_____	_____	_____
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the cap agreements.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the cap agreement with the names of individuals authorized to execute purchases, sales, or closeouts of cap contracts and found that the name of the individual was not on the list.	_____	_____	_____
24. Compared information regarding the cap, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
25. If the cap should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the cap, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the cap tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	_____	_____	_____

Effectiveness of Caps Used As Hedges and in Replication Transactions

27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the cap as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
28. If the cap was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

Legal Review

29. Read documentation indicating that the legal department reviewed the cap agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
Valuation			
31. Obtained the insurance company's policies and procedures for valuing caps and found that the insurance company determined the fair value of the cap in accordance with the policy described in the insurance company's procedures for the valuation of caps.	_____	_____	_____
32. Read documentation supporting the fair value of the cap and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized person.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>
_____	_____
_____	_____
_____	_____
_____	_____

Section 3—Collar Contracts

Findings

Procedures

No
Exception Exception N/A

Performed the following procedures on selected collar contracts to test internal control over collar transactions. Selected five percent of each type of collar transaction (that is, executions [entering into a collar transaction in which the net position at inception may result in either no cash outlay, cash received, or cash disbursed] and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.

Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into collar contracts.

2. For each collar selected for testing, read management's documentation describing the intended use of the collar and performed the following procedures, as applicable.

For collars used as a hedge—

3. Determined that the documentation described the following:

a. The risk hedged

b. How the hedge was consistent with the overall risk management strategy

c. How the collar was expected to be effective in offsetting the exposure

d. The approach in assessing the effectiveness of the hedge

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
4. Determined that the following items were documented:			
a. The purpose(s) of the collar as a hedge	_____	_____	_____
b. The terms of the collar, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the collar hedged	_____	_____	_____
d. Evidence that the collar continued to be an effective hedge	_____	_____	_____
e. Evidence that the contract was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____
If the collar was an exact offset of an outstanding collar—			
5. Read documentation indicating that the collar offset an outstanding collar previously purchased or sold by the insurance company and that the collar was an exact offset of the market risk of the collar being offset.	_____	_____	_____
For collars used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the collar was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The terms of the collar, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
For all selected collars including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize collar transactions. Compared the name of the individual who authorized the collar transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the collar transaction with names on the list and found the name of the counterparty on the respective qualified or non-qualified list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade collar contracts. Compared the name of the individual who executed the execution or closeout of the collar contract with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments relating to collars. Compared the name of the individual who approved any payment relating to the collar with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the collar with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the collar with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the execution or closeout of the collar and found that the execution or closeout was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade collars and found that the name was not on the list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
18. Compared the terms of the collar contract, as stated on the deal ticket and confirmation, with the terms of the collar contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly or quarterly) indicating that the insurance company determined that its accounting records for collars, tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the collar agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the collar agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the collar agreement and found them to be in agreement.	_____	_____	_____
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the collar agreement.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the collar contracts with the names of individuals authorized to enter into trades, executions, or closeouts of collar contracts and found that the name of the individual was not on the list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
24. Compared information regarding the collar, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
25. If the collar should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the collar, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the collar tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	_____	_____	_____

Effectiveness of Collars Used As Hedges and in Replication Transactions

27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the collar as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
28. If the collar was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
Legal Review			
29. Read documentation indicating that the legal department reviewed the collar agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	_____	_____	_____

Valuation

31. Obtained the insurance company's policies and procedures for valuing collars and found that the insurance company determined the fair value of the collar in accordance with the policy described in the insurance company's procedures for the valuation of collars.	_____	_____	_____
32. Read documentation supporting the fair value of the collar and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>
_____	_____
_____	_____
_____	_____
_____	_____

Section 4—Floor Contracts

Procedures

<u>Findings</u>		
<u>No</u>		
<u>Exception</u>	<u>Exception</u>	<u>N/A</u>

Performed the following procedures on selected floor contracts to test internal control over floor transactions. Selected five percent of each type of floor transaction (that is, purchases [premium disbursements], sales [premium receipts], and closeouts [closings and settlements of the position]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.

Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into floor contracts.
2. For each floor selected for testing, read management's documentation describing the intended use of the floor and performed the following procedures, as applicable.

_____	_____	_____
_____	_____	_____

For floors used as a hedge—

3. Determined that the documentation described the following:
 - a. The risk hedged
 - b. How the hedge was consistent with the overall risk management strategy
 - c. How the floor was expected to be effective in offsetting the exposure
 - d. The approach in assessing the effectiveness of the hedge

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
4. Determined that the following items were documented:			
a. The purpose(s) of the floor as a hedge	_____	_____	_____
b. The terms of the floor, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the floor hedged	_____	_____	_____
d. Evidence that the floor continued to be an effective hedge	_____	_____	_____
e. Evidence that the floor was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____
If the floor was an exact offset of an outstanding floor—			
5. Read documentation indicating that the floor offset an outstanding floor previously purchased or sold by the insurance company and that the floor was an exact offset of the market risk of the floor being offset.			
For floors used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the floor was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The terms of the floor, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
For all selected floors including those that are a part of a replication transaction—			
8. Obtained a list of individuals approved by the board of directors or a committee thereof who had the authority to authorize floor transactions. Compared the name of the individual who authorized the floor transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount or strike price exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the floor transaction with names on the list and found the name of the counterparty on the respective qualified or non-qualified list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or a committee thereof to trade floor contracts. Compared the name of the individual who executed the purchase, sale, or closeout of the floor with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments relating to floors. Compared the name of the individual who approved any payment relating to the floor with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the floor with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the floor with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the purchase, sale, or closeout of the floor and found that the purchase, sale, or closeout was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade floors and found that the name was not on the list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
18. Compared the terms of the floor contract, as stated on the deal ticket and confirmation, with the terms of the floor contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly or quarterly), that the insurance company determined that its accounting records for floors, tested in procedure 18, agreed with or reconciled to the related control account; for example, the subsidiary ledger to the general ledger.	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the floor agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the floor agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the floor agreement and found them to be in agreement.	_____	_____	_____
22. Obtained documentation for one reporting period (for example, monthly or quarterly), indicating that the insurance company physically inventoried the floor agreements.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the floor agreement with the names of individuals authorized to execute purchases, sales, or closeouts of floor contracts and found that the name was not on the list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
24. Compared information regarding the floor, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
25. If the floor should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the floor, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
26. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to the floor tested, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	_____	_____	_____

Effectiveness of Floors Used As Hedges and in Replication Transactions

27. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the floor as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
28. If the floor was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
Legal Review			
29. Read documentation indicating that the legal department reviewed the floor agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
30. Read documentation indicating that the legal department updated its assessment of agreement enforceability at least annually.	_____	_____	_____
Valuation			
31. Obtained the insurance company's policies and procedures for valuing floors and found that the insurance company determined the fair value of the floor in accordance with the policy described in the insurance company's procedures for the valuation of floors.	_____	_____	_____
32. Read documentation supporting the fair value of the floor and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>
_____	_____
_____	_____
_____	_____
_____	_____

Section 5—Forward Contracts

Procedures

Performed the following procedures on selected forward contracts to test internal control over forward transactions. Selected five percent of each type of forward transaction, with the selections distributed throughout the year. These are, (1) forward contracts entered into to make delivery, (2) forward contracts entered into to take delivery, (3) forward contracts settled by making delivery, (4) forward contracts settled by taking delivery, (5) forward contracts settled by cash. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.

Findings

<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
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Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into forward contracts.
2. For each forward selected for testing, read management's documentation describing the intended use of the forward and performed the following procedures, as applicable.

For forward contracts used as a hedge—

3. Determined that the documentation describes the following:
 - a. The risk hedged
 - b. How the hedge was consistent with the overall risk management strategy
 - c. How the forward was expected to be effective in offsetting the exposure
 - d. The approach in assessing the effectiveness of the hedge

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
4. Determined that the following items were documented:			
a. The purpose(s) of the forward as a hedge	_____	_____	_____
b. The terms of the forward, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the forward hedged	_____	_____	_____
d. The specific forward contract used in the hedge	_____	_____	_____
e. Evidence that the forward continued to be an effective hedge	_____	_____	_____
f. Evidence that the forward was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____
If the forward was an exact offset of an outstanding forward—			
5. Read documentation indicating that the forward offset an outstanding forward previously purchased or sold by the insurance company and that the forward was an exact offset of the market risk of the forward being offset.	_____	_____	_____
For forwards used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
c. How the forward was expected to be effective in replicating the investment characteristic of the replicated investment	_____	_____	_____
d. The approach for assessing the effectiveness of the replication transaction	_____	_____	_____
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The terms of the forward contract, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
For all selected forwards, including those that are a part of the replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize forward transactions. Compared the name of the individual who authorized the forward transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the forward transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	_____	_____	_____
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade forward contracts. Compared the name of the individual who executed the purchase or sale of the forward with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve settlements or payments related to forward contracts. For the purchase and any transaction subsequent to purchase, compared the name of the individual who approved any payment or settlement of funds in connection with the forward contract with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any settlement or payment relating to the forward with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the forward with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
16. Obtained the deal ticket and confirmation for the purchase or sale of the forward contract and found that the purchase or sale was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade forwards and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the forward contract, as stated on the deal ticket and confirmation, with the terms of the forward contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined that its accounting records for forwards, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the forward contract. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the forward contract and found that the insurance company either (a) obtained a statement from the custodian confirming the existence of the forward contract, (b) physically inventoried the forward contract, or (c) obtained a statement from the counterparty acknowledging the existence of the forward contract.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the forward with the names of individuals authorized to execute purchases and sales of forwards and found that the name was not on the list.	_____	_____	_____
23. Compared information regarding the forward, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
24. If the forward should have been included in the monitoring analysis separately tested in step 10 within section 1, "All Derivative Types," compared information regarding the forward, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____

Effectiveness of Forward Contracts Used As Hedges and in Replication Transactions

25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the forward as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
26. If the forward was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
Legal Review			
27. Read documentation indicating that the legal department reviewed the forward contract to assess contract compliance with the DUP and enforceability.	_____	_____	_____
28. Read documentation indicating that the legal department updated its assessment of contract enforceability at least annually.	_____	_____	_____
Valuation			
29. Obtained the insurance company's policies and procedures for valuing forwards and found that the insurance company determined the fair value of the forward in accordance with the policy described in the insurance company's procedures for valuation of forwards.	_____	_____	_____
30. Read documentation supporting the fair value of the forward contract and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>

Section 6—Futures Contracts

Procedures

Findings

<u>No</u>		
<u>Exception</u>	<u>Exception</u>	<u>N/A</u>

Performed the following procedures on selected futures contracts to test internal control over futures transactions. Selected five percent of each type of futures transaction, with the selections distributed throughout the year. These are purchases, sales, and cash settlements (closeouts of a position). If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.

Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade futures.

2. For each futures transaction selected for testing, read management's documentation describing the intended use of the futures and performed the following procedures, as applicable.

For futures used as a hedge—

3. Determined that the documentation describes the following:
 - a. The risk hedged
 - b. How the hedge was consistent with the overall risk management strategy
 - c. How the futures position was expected to be effective in offsetting the exposure
 - d. The approach in assessing the effectiveness of the hedge

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
4. Determined that the following items were documented:			
a. The purpose(s) of the futures as a hedge	_____	_____	_____
b. The terms of the futures transaction and the name of the exchange and firm(s) handling the trade	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the futures transaction hedged	_____	_____	_____
d. Evidence that the futures contract continued to be an effective hedge	_____	_____	_____
e. Evidence that the futures position was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for futures transactions; for example, the notional amount or underlying	_____	_____	_____
For futures transactions that were an exact offset of an outstanding futures transaction—			
5. Read documentation indicating that the futures transaction offset an outstanding futures position previously purchased or sold by the insurer and that the futures transaction was an exact offset of the market risk of the futures position being offset.	_____	_____	_____
For futures used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the futures position was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The terms of the futures transaction and the name of the exchange and the firm(s) handling the trade	_____	_____	_____
c. The specific futures contract used in the replication	_____	_____	_____
For all selected futures including those that are a part of the replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize futures trades. Compared the name of the individual who authorized the futures transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____
10. Obtained a list of individuals authorized by the board of directors or committee thereof to trade futures contracts. Compared the name of the individual who executed the purchase or sale of the futures contract with the names on the list and found the name of the individual on the list.	_____	_____	_____

Findings

Procedures

No
Exception Exception N/A

11. Obtained a list of individuals authorized to approve settlements or disbursements related to futures transactions. For purchases and transactions subsequent to purchase or sale of the futures contract, compared the name of the individual who approved any settlement of funds relating to the futures with the names on the list and found the name of the individual on the list.

12. Compared the name of the individual who approved any payment relating to the futures with the name of the individual who approved entering into the contract and found that the names were different.

13. Compared the name of the individual who received cash or other consideration in connection with the futures with the name of the individual who entered into the contract and found that the names of the individuals were different.

14. Obtained the deal ticket and confirmation for the purchase, expiration, or sale of the futures contracts and found that the purchase, sale, or expiration of the futures contract was confirmed by the deal ticket and confirmation.

15. Compared the terms of the futures transaction, as stated on the deal ticket and confirmation, with the terms of the transaction recorded in the insurance company's accounting records and found them to be in agreement.

16. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined that its accounting records for futures, tested in procedure 15, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
17. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the futures contracts and found that the insurance company obtained statements from the futures counterparty(ies) or broker(s) confirming the futures transactions and positions.	_____	_____	_____
18. Compared information regarding the futures contract, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
19. If the futures position should have been included in the monitoring analysis separately tested in procedure 10 within section 1, " All Derivative Types," compared information regarding the futures contract, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____

Effectiveness of Futures Used As Hedges and in Replication Transactions

20. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the futures position as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
21. If the futures position was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the company policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
Valuation			
22. Obtained the insurance company's policies and procedures for valuing positions and found that the insurance company determined the valuation of the futures contract in accordance with the policy described in the insurance company's procedures for valuation of futures.	_____	_____	_____
23. Read documentation supporting the market price of the futures contract and found that the market price was obtained from an independent source.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>
_____	_____
_____	_____
_____	_____
_____	_____

Section 7—Option Contracts

Procedures

<u>Findings</u>		
<u>No</u>	<u>Exception</u>	<u>Exception</u>
<u>Exception</u>	<u>Exception</u>	<u>N/A</u>

Performed the following procedures on selected option contracts to test internal control over option transactions. Selected five percent of each type of option transaction (that is, purchases, sales, expirations, and exercises), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.

Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade or enter into option contracts.
2. For each option selected for testing, read management's documentation describing the intended use of the option and performed the following procedures, as applicable.

_____	_____	_____
_____	_____	_____

For options used as a hedge—

3. Determined that the documentation described the following:
 - a. The risk hedged
 - b. How the hedge was consistent with the overall risk management strategy
 - c. How the option was expected to be effective in offsetting the exposure
 - d. The approach in assessing the effectiveness of the hedge

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
4. Determined that the following items were documented:			
a. The purpose(s) of the option as a hedge	_____	_____	_____
b. For over-the-counter (OTC) options, the terms of the option, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. For exchange-traded options, the term of the option, the name of the exchange, and the name of the firm(s) handling the trade	_____	_____	_____
d. The assets or liabilities (or portion thereof) that the option hedged	_____	_____	_____
e. For OTC and exchange-traded options, the specific option used in the hedge	_____	_____	_____
f. Evidence that the option continued to be an effective hedge	_____	_____	_____
g. Evidence that the option was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures, for entering into hedge transactions; for example, the notional amount, or underlying	_____	_____	_____
If the option transaction was (a) for income generation and was for the sale of a call option on securities or (b) an exact offset to an outstanding option—			
5. Read the documentation supporting the transaction which indicated that the insurance company was holding or could immediately acquire through the exercise of options, warrants, or conversion rights already owned, the underlying securities during the entire period the option was outstanding.	_____	_____	_____
6. Read documentation indicating that the option offset an outstanding option previously purchased or sold by the insurance company and that the option was an exact offset to the market risk of the option being offset.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
For options used in a replication transaction—			
7. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the option was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____
8. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The specific option used in the replication	_____	_____	_____
c. For OTC options, the terms of the option, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
d. For exchange-traded options, the name of the exchange and the firm(s) handling the trade	_____	_____	_____
For all selected options, including those that are a part of a replication transaction—			
9. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize option transactions. Compared the name of the individual who authorized the option transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____

Findings

Procedures

<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
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10. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.

_____	_____	_____
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11. Obtained a list of *qualified* and *nonqualified* counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the option transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.

_____	_____	_____
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12. For OTC options, determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 11.

_____	_____	_____
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13. Obtained a list of individuals authorized by the board of directors or committee thereof to trade option contracts. Compared the name of the individual who executed the purchase, sale, or exercise of the option with the names on the list and found the name of the individual on the list.

_____	_____	_____
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14. Obtained a list of individuals authorized to approve payments relating to options contracts. Compared the name of the individual who approved any payment relating to the option with the names on the list and found the name of the individual on the list.

_____	_____	_____
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<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
15. Compared the name of the individual who approved any payment relating to the option with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
16. Compared the name of the individual who received cash or other consideration in connection with the option with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
17. Obtained the deal ticket and confirmation for the purchase, sale, or exercise of the option and found that the purchase, sale, or exercise of the option was confirmed by the counterparty or firm handling the transaction.	_____	_____	_____
18. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade options and found that the name was not on the list.	_____	_____	_____
19. Compared the terms of the option contract, as stated on the deal ticket and confirmation, with the terms of the option contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
20. Obtained documentation for one reporting period, (for example, monthly or quarterly), indicating that the insurance company determined whether its accounting records for options, tested in procedure 19, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
21. Obtained the accounting record documenting modifications, if any, to the option transaction. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
22. Obtained documentation for one reporting period, (for example, monthly or quarterly), indicating that the insurance company obtained a statement from the counterparty confirming the existence of the option position.	_____	_____	_____
23. Using the list of authorized traders obtained in procedure 13, compared the name of the individual who had custody of or access to the option documentation with the names of individuals authorized to purchase, sell, or exercise the option and found that the name was not on the list.	_____	_____	_____
24. Compared information regarding the option, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
25. If the option should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the option, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____

Effectiveness of Options Used As Hedges and in Replication Transactions

26. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the option as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
27. If the option was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
Legal Review			
28. Read documentation indicating that the legal department reviewed the option agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
29. Read documentation indicating that the legal department updated its assessment of legal enforceability of the OTC option agreement at least annually.	_____	_____	_____
Valuation			
30. Obtained the insurance company's policies and procedures for valuing options and found that the insurance company determined the fair value of OTC options and the market price of exchange-traded options, in accordance with the policy described in the insurance company's procedures for the valuation of options.	_____	_____	_____
31. Read documentation supporting the fair value for OTC options and the market price of exchange-traded options and found that the fair value or market value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>
_____	_____
_____	_____
_____	_____
_____	_____

Section 8—Swap Contracts

Findings.

Procedures

No
Exception Exception N/A

Performed the following procedures on selected swap contracts to test internal control over swap transactions. Selected five percent of each type of swap transaction (that is, executions [purchases] and closeouts [sales]), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in fewer than four items, selected four or fewer items that represented all the transactions of that type.

Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to enter into swap agreements.

2. For each swap agreement selected for testing, read management's documentation describing the intended use of the swap agreement and performed the following procedures, as applicable.

_____	_____	_____
_____	_____	_____

For swaps used as a hedge—

3. Determined that the documentation describes the following:
 - a. The risk hedged
 - b. How the hedge was consistent with the overall risk management strategy
 - c. How the swap was expected to be effective in offsetting the exposure
 - d. The approach in assessing the effectiveness of the hedge

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
4. Determined that the following items were documented:			
a. The purpose(s) of the swap as a hedge	_____	_____	_____
b. The terms of the swap, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the swap hedged	_____	_____	_____
d. Evidence that the swap continued to be an effective hedge	_____	_____	_____
e. Evidence that the swap was consistent with the insurance company's parameters, as specified in the DUP or applicable policies and procedures, for entering into swap agreements; for example, the notional amount or underlying	_____	_____	_____
For swaps that were an exact offset of an outstanding swap—			
5. Read documentation that indicated that the swap offset a swap previously purchased or sold, and that the swap was an exact offset to the market risk of the swap being offset.	_____	_____	_____
For swaps used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the swap was expected to be effective in replicating the investment characteristic of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The terms of the swap, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
For all selected swaps including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize swap transactions. Compared the name of the individual who authorized the swap transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transactions tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the swap agreement with names on the list and found the name of the counterparty on the respective qualified or non-qualified list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade swap contracts. Compared the name of the individual who executed the swap with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve settlements or disbursements related to swaps. For purchases and any interim settlements or closeouts of the swap subsequent to purchase, compared the name of the individual who approved any settlement of funds relating to the swap with the names on the list and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the swap with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the swap with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the purchase, execution, or closeout of the swap and found that the purchase, execution, or closeout of the swap was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade swaps and found that the name was not on the list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
18. Compared the terms of the swap contract, as stated on the deal ticket and confirmation, with the terms of the swap contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly, or quarterly), that the insurance company determined whether its accounting records for swaps, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the swap agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the swap agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the swap agreement and found them to be in agreement.	_____	_____	_____
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the swap agreement with the names of individuals authorized to execute swap agreements and found that the name was not on the list.	_____	_____	_____
23. Compared information regarding the swap, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
24. If the swap should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the swap, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
25. Read accounting documentation indicating that the insurance company monitored periodic cash settlements related to swap transactions, meaning, the insurance company had controls in place to determine that periodic cash settlements, if any, were received.	_____	_____	_____

Effectiveness of Swaps Used As Hedges and in Replication Transactions

26. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the swap as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
27. If the swap was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

Legal Review

28. Read documentation indicating that the legal department reviewed the swap agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
29. Read documentation indicating that the legal department updated its assessment of the enforceability of the swap agreement at least annually.	_____	_____	_____

Findings

Procedures

<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
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Valuation

30. Obtained the insurance company's policies and procedures for valuing swaps and found that the insurance company determined the fair value of the swap in accordance with the policy described in the insurance company's procedures for valuation of swaps.

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31. Read documentation supporting the fair value of the swap and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.

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Description of Exceptions if Any

Procedure Number

Description of Exception

Section 9—Swaption Contracts

Procedures

<u>Findings</u>		
<u>No</u>	<u>Exception</u>	<u>N/A</u>

Performed the following procedures on selected swaption contracts to test internal control over swaption transactions. Selected five percent of each type of swaption transaction with the selections distributed throughout the year. These are executions (purchases) and closeouts (sales). If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all the transactions of that type.

Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to buy or sell swaptions.

_____	_____	_____
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2. For each swaption contract selected for testing, read management's documentation describing the intended use of the swaption and performed the following procedures, as applicable.

_____	_____	_____
-------	-------	-------

For swaptions used as a hedge—

3. Determined that the documentation describes the following:

a. The risk hedged

_____	_____	_____
-------	-------	-------

b. How the hedge was consistent with the overall risk management strategy

_____	_____	_____
-------	-------	-------

c. How the swaption was expected to be effective in offsetting the exposure

_____	_____	_____
-------	-------	-------

d. The approach in assessing the effectiveness of the hedge

_____	_____	_____
-------	-------	-------

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
4. Determined that the following items were documented:			
a. The purpose(s) of the swaption as a hedge	_____	_____	_____
b. The terms of the swaption, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
c. The assets or liabilities (or portion thereof) that the swaption hedged	_____	_____	_____
d. Evidence that the swaption continued to be an effective hedge	_____	_____	_____
e. Evidence that the swaption was consistent with the insurance company's parameters, as specified in the DUP or applicable policies and procedures, for entering into swaption agreements; for example, the notional amount or underlying	_____	_____	_____
For swaptions that were an exact offset of an outstanding swaption—			
5. Read documentation indicating that the swaption offset an outstanding swaption and that the swaption was an exact offset of the market risk of the swaption being offset.	_____	_____	_____
For swaptions used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____
c. How the swaption was expected to be effective in replicating the investment characteristic of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No</u> <u>Exception</u>	<u>Exception</u>	<u>N/A</u>
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The terms of the swaption, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
For all selected swaptions including those that are a part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof, who had the authority to authorize swaptions. Compared the name of the individual who authorized the swaption transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transactions tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support and found evidence of approval of the transaction tested.	_____	_____	_____
10. Obtained a list of qualified and nonqualified counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the swaption transaction with names on the list and found the name of the counterparty on the respective qualified or nonqualified list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
11. Determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade swaption contracts. Compared the name of the individual who executed the swaption with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve settlements or disbursements related to swaption agreements. Compared the name of the individual who approved settlements and disbursements relating to the swaption with the names on the list and found the name on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the swaption with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the swaption with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____
16. Obtained the deal ticket and confirmation for the purchase, sale, modification, or closeout of the swaption and found that the purchase, sale, modification, or closeout was confirmed by the counterparty.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade swaptions and found that the name was not on the list.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
18. Compared the terms of the swaption contract, as stated on the deal ticket and confirmation, with the terms of the swaption contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period (for example, monthly or quarterly), that the insurance company determined whether its accounting records for swaptions, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the swaption agreement. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. Compared the terms of the swaption agreement recorded in the insurance company's accounting records with the terms shown in the executed copy of the swaption agreement and found them to be in agreement.	_____	_____	_____
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody or access to the swaption agreement with the names of individuals authorized to execute swaption agreements and found that the name was not on the list.	_____	_____	_____
23. Compared information regarding the swaption, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
24. If the swaption should have been included in the monitoring analysis separately tested in procedure 10 within section 1, "All Derivative Types," compared information regarding the swaption, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____
Effectiveness of Swaptions Used As Hedges and in Replication Transactions			
25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the swaption as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
26. If the swaption was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____
Legal Review			
27. Read documentation indicating that the legal department reviewed the swaption agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
28. Read documentation indicating that the legal department updated its assessment of the enforceability of the swaption agreement at least annually.	_____	_____	_____
Valuation			
29. Obtained the insurance company's policies and procedures for valuing swaptions and found that the insurance company determined the fair value of the swaption in accordance with the policy described in the insurance company's procedures for valuation of swaptions.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
30. Read documentation supporting the fair value of the swaption and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>
_____	_____
_____	_____
_____	_____
_____	_____

Section 10—Warrant Contracts

Procedures

Performed the following procedures on selected warrant contracts to test internal control over warrant transactions. Selected five percent of each type of warrant transaction (that is, purchases, sales, expirations, and exercises), with the selections distributed throughout the year. If five percent of a given type of transaction exceeded 40, the number of items selected for that type of transaction was limited to 40. If five percent of a type of transaction resulted in less than four items, selected four or fewer items that represented all of the transactions of that type.

Findings

<u>No</u>	<u>Exception</u>	<u>Exception</u>	<u>N/A</u>
-----------	------------------	------------------	------------

Reporting

1. Read the insurance company's derivative use plan (DUP) and any amendments thereto and found that the DUP permits the insurance company to trade or enter into warrant contracts.

2. For each warrant selected for testing, read management's documentation describing the intended use of the warrant and performed the following procedures, as applicable.

_____	_____	_____
_____	_____	_____

For warrants used as a hedge—

3. Determined that the documentation described the following:
 - a. The risk hedged
 - b. How the hedge was consistent with the overall risk management strategy
 - c. How the warrant was expected to be effective in offsetting the exposure
 - d. The approach in assessing the effectiveness of the hedge

_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
4. Determined that the following items were documented:			
a. The purpose(s) of the warrant as a hedge	_____	_____	_____
b. For exchange-traded warrants, the term of the warrant, the name of the exchange, and the name of the firm(s) handling the trade	_____	_____	_____
c. For over-the-counter (OTC) warrants, the terms of the warrant, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
d. The assets or liabilities (or portion thereof) that the warrant hedged	_____	_____	_____
e. Evidence that the warrant continued to be an effective hedge	_____	_____	_____
f. Evidence that the warrant was consistent with the insurance company's parameters, as specified in the DUP or applicable company policies and procedures for entering into hedge transactions; for example, the notional amount or underlying	_____	_____	_____
If the warrant transaction was an exact offset of an outstanding warrant—			
5. Read documentation indicating that the warrant transaction offset an outstanding warrant previously purchased or sold by the insurance company and that the warrant was an exact offset of the market risk of the warrant being offset	_____	_____	_____
For warrants used in a replication transaction—			
6. Determined that the documentation described the following:			
a. The investment type and characteristics replicated	_____	_____	_____
b. How the replication was consistent with the overall management investment strategy	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
c. How the warrant was expected to be effective in replicating the investment characteristics of the replicated investment	_____	_____	_____
d. The approach in assessing the effectiveness of the replication transaction	_____	_____	_____
7. Determined that the following items were documented:			
a. The instruments used in the replication and the investment type and characteristics replicated	_____	_____	_____
b. The specific warrant used in the replication	_____	_____	_____
c. For exchange-traded warrants, the name of the exchange and the firm(s) handling the trade	_____	_____	_____
d. For OTC warrants, the terms of the warrant, the name of the counterparty, and the counterparty exposure amount	_____	_____	_____
For all selected warrants including those that are part of a replication transaction—			
8. Obtained a list of individuals, approved by the board of directors or a committee thereof who had the authority to authorize warrant transactions. Compared the name of the individual who authorized the warrant transaction with the names on the list and found the name of the individual on the list.	_____	_____	_____
9. Based on the details of the transaction identified in procedure 2 and company policy, compared the terms of the transaction with the insurance company's policy regarding the requirement for the board of directors or a committee thereof to authorize the specific transaction tested; for example, a transaction in which the notional amount exceeded a limit requiring additional approval. If the board of directors or a committee thereof was required to approve the transaction, read minutes of the board of directors or a committee thereof or other appropriate support, and found evidence of approval of the transaction tested	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
10. Obtained a list of <i>qualified</i> and <i>nonqualified</i> counterparties, approved by the board of directors or a committee thereof. Compared the name of the counterparty involved in the warrant transaction with names on the list, and found the name of the counterparty on the respective qualified or nonqualified list.	_____	_____	_____
11. For OTC warrants, determined that the counterparty was listed as qualified or nonqualified in the analysis used for monitoring the insurance company's limitations on counterparty exposure, consistent with the classification in the listing obtained in procedure 10.	_____	_____	_____
12. Obtained a list of individuals authorized by the board of directors or committee thereof to trade warrant contracts. Compared the name of the individual who executed the purchase, sale, or exercise of the warrant with the names on the list and found the name of the individual on the list.	_____	_____	_____
13. Obtained a list of individuals authorized to approve payments related to warrant contracts. Compared the name of the individual who approved any payment relating to the warrant with the names on the list, and found the name of the individual on the list.	_____	_____	_____
14. Compared the name of the individual who approved any payment relating to the warrant with the name of the individual who approved entering into the contract and found that the names were different.	_____	_____	_____
15. Compared the name of the individual who received cash or other consideration in connection with the warrant with the name of the individual who entered into the contract and found that the names of the individuals were different.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
16. Obtained the deal ticket and confirmation for the purchase, sale, or exercise of an exchange-traded warrant and found that the purchase, sale, or exercise was confirmed by the firm handling the transaction.	_____	_____	_____
17. Compared the name of the individual who received the deal ticket and confirmation with the names on a list of individuals authorized to trade warrants and found that the name was not on the list.	_____	_____	_____
18. Compared the terms of the warrant contract, as stated on the deal ticket and confirmation, with the terms of the warrant contract recorded in the insurance company's accounting records and found them to be in agreement.	_____	_____	_____
19. Obtained documentation for one reporting period, (for example, monthly or quarterly), that the insurance company determined whether its accounting records for warrants, tested in procedure 18, agreed with or reconciled to the related control account, (for example, the subsidiary ledger to the general ledger).	_____	_____	_____
20. Obtained the accounting record documenting modifications, if any, to the warrant transaction. Compared the name of the individual who approved the modification with a list of individuals authorized to approve modifications and found the name of the individual who approved the modification on the list.	_____	_____	_____
21. For one reporting period, (for example, monthly or quarterly), obtained the insurance company's documentation of the existence of the warrant contract and found that the insurance company either (a) obtained statements from the custodian confirming the existence of the warrant contracts or (b) physically inventoried the warrant contracts.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
22. Using the list of authorized traders obtained in procedure 12, compared the name of the individual who had custody of or access to the warrant contracts with the names of individuals authorized to execute purchases, sales, or exercises of warrants and found that the name was not on the list.	_____	_____	_____
23. Compared information regarding the warrant, such as type of derivative, notional amount, and fair value, with the comparable information included in the report to the board of directors or appropriate committee thereof and found them to be in agreement.	_____	_____	_____
24. If the warrant position should have been included in the monitoring analysis separately tested in procedure 10 of section 1, "All Derivative Types," compared information regarding the warrant, such as type of derivative, notional amount, and fair value, with the comparable information in the monitoring analysis and found them to be in agreement.	_____	_____	_____

Effectiveness of Warrants Used As Hedges and in Replication Transactions

25. Read the insurance company's documentation of effectiveness and found that the insurance company evaluated the effectiveness of the warrant as a hedge or replication in accordance with the policies regarding effectiveness.	_____	_____	_____
26. If the warrant was no longer effective as a hedge or replication, compared the action taken by the insurance company with the action required by the accounting policies and procedures and found that the action taken was consistent with the accounting policy.	_____	_____	_____

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
Legal Review			
27. Read documentation indicating that the legal department reviewed a nonexchange traded warrant agreement to assess contract compliance with the DUP and enforceability.	_____	_____	_____
28. Read documentation indicating that the legal department updated its assessment of enforceability of the nonexchange traded warrant agreement at least annually.	_____	_____	_____

Valuation

29. Obtained the insurance company's policies and procedures for valuing warrants and found that the insurance company determined the fair value of the warrant in accordance with the policy described in the insurance company's procedures for the valuation of warrants	_____	_____	_____
30. Read documentation supporting the fair value of warrants and found that the fair value was either (a) obtained from an independent source, (b) checked against an independent source, or (c) calculated internally by an authorized individual.	_____	_____	_____

Description of Exceptions if Any

<u>Procedure Number</u>	<u>Description of Exception</u>
_____	_____
_____	_____
_____	_____
_____	_____

Appendix C

Illustrative Management Representation Letter

[Responsible Party's Letterhead]

[Date]

[CPA Firm's Name and Address]

In connection with your engagement to apply the agreed-upon procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position 01-03, *Performing Agreed-Upon Procedures Engagements that Address Internal Control Over Derivative Transactions as Required by the New York State Insurance Law*, which were agreed to by management of ABC Insurance Company, solely to assist us in complying with the requirements of Section 1410(b)(5) of the New York State Insurance Law, as amended (the Law), which addresses the assessment of internal control over derivative transactions as defined in Section 1401(a) of the Law and Section 178.6 of Regulation No. 163 during the year ended December 31, 20XX, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement:

1. We are responsible for establishing and maintaining effective internal control over derivative transactions in accordance with the Law.
2. During the year ended December 31, 20XX, the internal control over derivative transactions was functioning in accordance with the policies and procedures set forth in the Company's derivative use plan (DUP) and related accounting policies and procedures. There have been no errors or fraud that would indicate a weakness in the internal control over derivative transactions.
3. We have disclosed to you all significant deficiencies in the design or operation of the internal control over derivative transactions that would adversely affect the Company's ability to function in accordance with the Company's DUP.
4. There have been no communications from regulatory agencies, internal auditors, or other practitioners or consultants relating to the internal control over derivative transactions, including communications received between December 31, 20XX and the date of this letter.
5. We have made available to you all information that we believe is relevant to the internal control over derivative transactions.
6. We have responded fully to all inquiries made to us by you during the engagement.

To the best of our knowledge and belief, no events have occurred subsequent to December 31, 20XX and through the date of this letter that would require adjustment to or modification of the findings of the agreed-upon procedures.

[Signature]

[Title]

[Signature]

[Title]

**Reporting on Controls Over Derivative
Transactions at Insurance Entities Task Force**

ALBERT J. REZNICEK, *Chair*
EDWARD F. BADER
DARRYL BRILEY
BEN B. KORBLY
EDWARD J. METZGER

DAVID A. NACHMAN
PAULA C. PANIK
ROBERT M. SOLITRO
MARY TODD STOCKER
DEBORAH H. WHITMORE

The AICPA is grateful to Jean Connolly, James S. Gerson, Laurel A. Hammer, Jay Matalon, and James M. Yanosy for their technical assistance with this document and also to Michael Moriarty of the New York State Department of Insurance for reviewing this document and providing recommendations.

AICPA Staff

CHARLES E. LANDES
Director
Audit and Attest Standards

JUDITH M. SHERINSKY
Technical Manager
Audit and Attest Standards

[The next page is 31,571.]

Section 11,380***Statement of Position 01-4
Reporting Pursuant to the Association for
Investment Management and Research
Performance Presentation Standards***

November 13, 2001

NOTE

This Statement of Position represents the recommendations of the AICPA's Investment Performance Statistics Task Force regarding the application of Statements on Standards for Attestation Engagements to engagements to report pursuant to the Association for Investment Management and Research Performance Presentation Standards. The Auditing Standards Board has found the recommendations in this Statement of Position to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be prepared to justify departures from the recommendations of this Statement of Position.

Introduction and Background

.01 The investment management industry is composed of a diverse group of financial entities, including registered investment companies, investment partnerships (such as venture capital funds and hedge funds), registered and nonregistered investment advisers, commodity pool operators and trading advisers, commercial and investment banks, and trust companies. Despite diverse financial structures and regulatory environments, these entities share the common goal of maximizing the rate of return on assets being managed. A presentation of an investment firm's past performance in managing proprietary or client funds can be a powerful tool for attracting new clients and maintaining the firm's client base. In recent years, market forces, including rapid industry growth, significant consolidation, fierce competition, and increased scrutiny from regulators and investors, have resulted in an increased focus on these types of presentations.

.02 To promote fair representation, full disclosure, and greater comparability in investment performance presentations, the Association for Investment Management and Research (AIMR) has developed the AIMR Performance Presentation Standards (AIMR-PPS® standards).¹ Although compliance with the AIMR-PPS standards is voluntary, an investment firm's

¹ The term "Association for Investment Management and Research Performance Presentation Standards" is abbreviated in this Statement of Position either as the AIMR-PPS standards or the standards. For information on the appropriate use of the AIMR-PPS registered trademark ®, see the AIMR Web site <http://www.aimr.org>.

claim of compliance with the AIMR-PPS standards is widely regarded as providing a competitive advantage. The AIMR-PPS standards include both required and recommended guidelines for composite construction, calculation methodology, presentation of results, and disclosure. First introduced in 1987, the AIMR-PPS standards represent suitable criteria² on which investment managers can base their investment return calculations and present their results. AIMR's Performance Presentation Standards Implementation Committee and Investment Performance Council oversee the continuing development of the AIMR-PPS standards and the Global Investment Performance Standards (GIPS® standards).

.03 In February 1999, AIMR issued the GIPS standards to provide a basis for readily accepted and comparable presentations of investment performance without regard to geographic location. At that time AIMR also took the first step in moving the AIMR-PPS standards toward a global investment performance standard by adding new requirements to bring them in line with the GIPS standards.

.04 In May 2001, AIMR took the next step in converging the AIMR-PPS standards with the GIPS standards by adopting and publishing on its Web site redrafted AIMR-PPS standards, the U.S. and Canadian version of GIPS. Because the GIPS standards are fundamentally based on the AIMR-PPS standards, the redraft of the AIMR-PPS standards was primarily a reorganization of the existing provisions. The AIMR-PPS standards indicate that investment firms already compliant with the standards will need to perform minimal additional work to continue to comply with the AIMR-PPS standards. The AIMR-PPS standards incorporate all the requirements and recommendations of the GIPS standards. All references to the AIMR-PPS standards in this Statement of Position (SOP) refer to the redrafted AIMR-PPS standards, the U.S. and Canadian version of GIPS.

.05 The AIMR-PPS standards recommend that firms obtain independent third-party verification of an investment firm's claim of compliance with the AIMR-PPS standards. Verification under the AIMR-PPS standards had previously consisted of two levels: Level I (firmwide verification) and Level II (verification of a specific composite). To encourage convergence of the AIMR-PPS standards and the GIPS standards, as of January 1, 2003, verification will only consist of the Level I procedures.³ In addition, an investment management firm may choose to have a more extensive, specifically focused performance examination of a specific composite presentation. It should be noted that AIMR's emphasis is on *firmwide* verification, which a firm *must* obtain concurrent with, or prior to, obtaining a performance examination of the performance results of any specific composite.

.06 The AIMR-PPS standards specify that Level I verifications and performance examinations (Level II) must be performed by an independent third-party "verifier."

² The AIMR-PPS standards provide suitable criteria, as defined in Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 2, AT sec. 101), for composite construction, calculation methodology, presentation of results, and disclosure. The criteria are available to users, as defined in Chapter 1 of SSAE No. 10, as they are posted to the AIMR Web site. The AIMR Web site also provides additional guidance on interpreting and applying the AIMR-PPS standards through a variety of means, including questions and answers, guidance statements, and subcommittee reports.

³ The requirements for a Level I verification under the AIMR-PPS standards are the same as those under the GIPS standards.

Scope

.07 This SOP provides guidance to practitioners for engagements to examine and report on aspects of an investment firm's compliance with the AIMR-PPS standards (a Level I verification engagement). It also provides guidance on engagements to examine and report on the performance results of specific composites in conformity with the AIMR-PPS standards (a performance examination [Level II]). Such examination engagements should be performed pursuant to Chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 2, AT sec. 101). As described herein, the AIMR-PPS standards require that such engagements use the criteria they set forth; consequently, users of this SOP should be familiar with the AIMR-PPS standards and interpretative guidance.

.08 This SOP supersedes two AICPA Notices to Practitioners: *Examination Engagements to Report on Investment Performance Statistics Based on Established or Stated Criteria*, issued by the AICPA's Investment Companies Committee in November 1995; and *Engagements to Report on Performance Presentation Standards of the Association for Investment Management and Research*, issued by the AICPA Auditing Standards Division in July 1993. This SOP also supersedes paragraphs 11.18 through 11.22 of the AICPA Audit and Accounting Guide *Audits of Investment Companies*, Chapter 11, "Independent Auditor's Reports and Management Representations."

Overview of the AIMR-PPS Standards

Firmwide Compliance With the AIMR-PPS Standards

.09 For an investment firm to claim compliance with the AIMR-PPS standards, the firm must meet *all* of the required elements of the AIMR-PPS standards on a *firmwide* basis. Firms are prohibited from claiming compliance "except for" one or more of the required standards. Firms that have met all of the required elements may include the following statement in performance presentations to clients:

[Insert name of firm] has prepared and presented this report in compliance with the Performance Presentation Standards of the Association for Investment Management and Research (AIMR-PPS®), the U.S. and Canadian version of the Global Investment Performance Standards (GIPS®). AIMR has not been involved in the preparation or review of this report.

.10 The AIMR-PPS standards must be applied on a firmwide basis. The AIMR-PPS standards state:

A firm may define itself as

- a. an entity registered with the appropriate national regulatory authority overseeing the entity's investment management activities; or
- b. an investment firm, subsidiary, or division held out to clients or potential clients as a distinct business unit (e.g., a subsidiary firm or distinct business unit managing private client assets may claim compliance for itself without its parent organization being in compliance);
- c. (until January 1, 2005), all assets managed to one or more base currencies (for firms managing global assets).

When presenting investment performance in compliance with the AIMR-PPS standards, an investment management firm must state how it defines itself as a “firm.”

.11 The AIMR-PPS standards establish both requirements and recommendations for investment firms to follow in preparing investment performance presentations. To claim firmwide compliance, an investment firm must adhere to the required standards. Adherence to the recommended standards is encouraged. The AIMR-PPS standards are divided into five sections that reflect the basic elements involved in presenting performance information:

Input Data: Consistency of input data is critical to effective compliance with the AIMR-PPS standards and establishes the foundation for full, fair, and comparable investment performance presentations. The standards provide the blueprint for a firm to follow in constructing this foundation.

Calculation Methodology: Achieving comparability among investment management firms’ performance presentations requires uniformity in methods used to calculate returns. The standards mandate the use of certain calculation methodologies (e.g., performance must be calculated using a time-weighted total rate of return method).

Composite Construction: A composite is an aggregation of a number of portfolios into a single group that represents a particular investment objective or strategy. The composite return is the asset-weighted average of the performance results of all the portfolios in the composite. Creating meaningful, asset-weighted composites is critical to the fair presentation, consistency, and comparability of results over time and among firms.

Disclosure: Disclosures allow firms to elaborate on the raw numbers provided in the presentation and give the end user of the presentation the proper context in which to understand the performance results. To comply with the AIMR-PPS standards, firms must disclose certain information about their performance presentation and the calculation methodology adopted by the firm. Although some disclosures are required of all firms, others are specific to certain circumstances, and thus may not be applicable to all situations.

Presentation and Reporting: After constructing the composites, gathering the input data, calculating the returns and determining the necessary disclosures, the firms must incorporate this information in presentations based on the guidelines set out in the AIMR-PPS standards for presenting the investment performance results. No finite set of guidelines can cover all potential situations or anticipate future developments in investment industry structure, technology, products, or practices. When appropriate, firms have the responsibility to include in AIMR-compliant presentations information not covered by the Standards.

.12 The AIMR-PPS standards also include four additional sections that address the calculation and presentation of performance for alternative asset categories (for example, real estate, venture and private placements, wrap-fee accounts, and after-tax returns).

.13 Practitioners who perform a Level I verification or a performance examination (Level II) pursuant to the AIMR-PPS standards should be familiar with those standards and the interpretative guidance, which are available on AIMR’s Web site.

Firmwide Verification and Performance Examination

Level I or Firmwide Verification

.14 A Level I verification tests:

- a. Whether the investment firm has complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis; and
- b. Whether the investment firm's processes and procedures are designed to calculate and present performance results in compliance with the AIMR-PPS standards.

.15 Level I verification is considered to be the primary level of verification because it tests the validity of a firm's claim of compliance on a *firmwide* basis rather than testing the claim for only one or more composites. Under Level I, a single verification report is issued with respect to the whole firm. The AIMR-PPS standards specify procedures that practitioners should perform for a Level I verification (see Section III and appendix D of the AIMR-PPS standards; those procedures are reproduced in appendix A [paragraph .39] of this SOP).

.16 According to the AIMR-PPS standards, when an investment firm has obtained a Level I verification, the firm may state that it is "Level I verified." This claim may or may not be accompanied by a presentation of performance history for a specific composite. A Level I verification, however, does *not* imply that the verifiers have examined the accuracy of the performance results of any particular composite presentation(s) that may accompany the verification report. (See paragraph .37.)

Performance Examination (Level II)

.17 In addition to a Level I verification, an investment firm may choose to have a more extensive, specifically focused examination of a specific composite presentation. Such an examination, for the purposes of the AIMR-PPS standards, is referred to as a performance examination (Level II). The AIMR-PPS standards identify objectives and suggested procedures for a performance examination (Level II) (see appendix B [paragraph .40] of this SOP). A performance examination (Level II) also requires a Level I verification to be performed prior to or concurrent with *any* performance examination (Level II).

Examination Engagement

Engagement Objectives

.18 To satisfy the required procedures set forth by the AIMR-PPS standards, practitioners should conduct an examination engagement pursuant to Chapter 1 of SSAE No. 10. For a Level I engagement, the practitioner's objective is to express an opinion on whether, in all material respects:

- a. The investment firm has complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis; and
- b. The investment firm's processes and procedures are designed to calculate and present performance results in compliance with the AIMR-PPS standards.

.19 For a performance examination (Level II), the practitioner's objectives include (a) expressing an opinion on a Level I engagement (see paragraph .18), and (b) expressing an opinion on whether the performance results of a specific composite are presented, in all material respects, in conformity with the AIMR-PPS standards.

Planning the Engagement

.20 SSAE No. 10 states that planning an attest engagement involves developing an overall strategy for the expected conduct and scope of the engagement. To develop such a strategy, practitioners need to have sufficient knowledge of the investment management industry and of the AIMR-PPS standards and interpretive guidance to enable them to understand adequately the events, transactions, and practices that, in their judgment, have a significant effect on the subject matter of the assertions.

.21 The examination should be conducted in accordance with attestation standards established by the AICPA. The engagement also should be conducted in accordance with the procedures set forth in the AIMR-PPS standards. This SOP is not intended to provide all the required and recommended procedures set forth in the AIMR-PPS standards or all the applicable attestation standards established by the AICPA.

Establishing an Understanding With the Client

.22 The practitioner should establish an understanding with the client regarding the services to be performed to reduce the risk that either the practitioner or the client may misinterpret the needs or expectations of the other party. The understanding should include the objectives of the engagement, management's responsibilities, the practitioner's responsibilities, limitations of the engagement, and any other limitations on the use of the practitioner's name and report. The understanding should include a statement that, if the client intends to use the practitioner's report on the examination, or refer to the practitioner, in connection with any sales or advertising literature, a draft of such literature should be provided to the practitioner for his or her review and comment prior to issuance.

.23 The practitioner should document the understanding in the working papers, preferably through a written communication with the client, such as an engagement letter (see appendix C [paragraph .41] of this SOP for a sample engagement letter).

Obtaining Sufficient Evidence

.24 In conducting an attest examination, the practitioner accumulates sufficient evidence to restrict attestation risk⁴ to a level that is, in the practitioner's professional judgment, appropriately low for the high level of assurance that may be imparted by his or her report. A practitioner should select from all available procedures—that is, procedures that assess inherent and control risk and restrict detection risk—any combination that can restrict attestation risk to such an appropriately low level.

.25 As noted previously, the AIMR-PPS standards specify procedures that practitioners should perform for a Level I verification in Section III and

⁴ See SSAE No. 10, Chapter 1, paragraph 1.45, footnote 9, for the definition of *attestation risk*.

appendix D of the AIMR-PPS standards; those procedures are reproduced in appendix A [paragraph .39] of this SOP. Since a performance examination (Level II) requires a Level I verification, the practitioner should perform those procedures required for a Level I verification in *any* examination of a firm's investment performance prepared pursuant to AIMR-PPS standards. At a minimum, practitioners should follow the procedures required by the AIMR-PPS standards.

.26 In addition, practitioners who are engaged to conduct a performance examination (Level II) of one or more specific composite presentations should consider the objectives specified in appendix D of the AIMR-PPS standards in conducting a performance examination and should select from all available procedures any combination that can limit the risk of errors occurring and not being detected during the examination to an appropriately low level (see appendix B [paragraph .40] of this SOP for objectives and suggested procedures identified by the AIMR-PPS standards).

.27 Regardless of the scope of the engagement, the practitioner should obtain sufficient evidence to provide a reasonable basis for the opinion expressed in the report (see the second standard of fieldwork in Chapter 1 of SSAE No. 10).

.28 When the practitioner is engaged to conduct a performance examination (Level II) of one or more composites subsequent to the performance and issuance of a report on a Level I verification engagement, the practitioner should update his or her understanding of relevant controls and inquire about any other changes that may affect the planning and conduct of the performance examination (Level II).

.29 The AIMR-PPS standards require that investment firms report, at a minimum, 10 years of investment performance (or performance since inception of the firm/composite if the period since inception is less than 10 years) to claim compliance with the standards. During a composite-specific performance examination, the practitioner should be alert for circumstances and events that affect prior period performance results presented or the adequacy of disclosures concerning those prior period performance results. In updating his or her report on the performance results for prior periods, the practitioner should consider the effects of any such circumstances or events coming to his or her attention. An updated report on performance results for a prior period should be distinguished from a reissuance of a previous report, since the practitioner, in issuing an updated report, considers information that he or she has become aware of during the examination of the current period performance results and because an updated report is issued in conjunction with the practitioner's report on the performance results for the current period. Although the investment firm must present 10 years of investment performance results, a Level I verification or a performance examination (Level II) can cover any time period.

Representation Letter

.30 As part of a Level I verification, AIMR requires the practitioner to obtain a representation letter from the client firm confirming major policies and any other specific representations made to the practitioner during the engagement. The practitioner also ordinarily should obtain a representation letter as part of a performance examination (Level II). Examples of matters that might appear in a representation letter include the following:

- a.* A statement acknowledging management's responsibility for their assertions and, where applicable, for the preparation of specific statements of performance results.

- b. A statement acknowledging responsibility for selecting the criteria (SSAE No. 10, paragraph 1.60).
- c. A statement acknowledging responsibility for determining that such criteria (AIMR-PPS standards) are appropriate for its purposes, where the responsible party is the client (SSAE No. 10, paragraph 1.60).
- d. Management's assertions about (1) compliance with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis, (2) the processes and procedures designed to calculate and present performance results in compliance with the AIMR-PPS standards, and (3) where applicable, a statement that the specific composite statements of performance results are presented in conformity with the AIMR-PPS standards. Management's assertions should address the same periods to be covered by the practitioner's examination report.
- e. A statement that all known matters contradicting the assertions and any communication from regulatory agencies affecting the subject matter or the assertions have been disclosed to the practitioner.
- f. A statement that there has been no (1) fraud involving management or employees who have significant roles in the company's processes and procedures relating to compliance with the AIMR-PPS standards or (2) fraud involving others that could have a material effect on the company's compliance with the AIMR-PPS standards.
- g. Availability of all records relevant to the examination.
- h. A statement that management is responsible for maintaining sufficient books and records to substantiate performance as required under Rule 204 of the Investment Advisers Act of 1940 and that management has maintained such records to comply with those requirements.
- i. A statement that any known events subsequent to the period (or point in time) of the subject matter being reported on that would have a material effect on the subject matter or the assertions have been disclosed to the practitioner.
- j. Other matters as the practitioner deems appropriate.

Appendix D [paragraph .42] of this SOP contains a sample management representation letter, including additional representations that may be appropriate for a performance examination (Level II). Management's refusal to furnish all appropriate written representations constitutes a limitation on the scope of the examination sufficient to preclude rendering an opinion (see paragraph .32 of this SOP). Further, the practitioner should consider the effects of management's refusal on his or her ability to rely on other management representations.

Reporting

.31 SSAE No. 10 permits the practitioner to report either on the assertions or directly on the subject matter to which the assertions relate. The illustrative reports in Appendixes E [paragraph .43] and F [paragraph .44] present both reporting options.

.32 After conducting the procedures for a Level I verification, the practitioner may conclude that the investment firm is not in compliance with the standards or that the records of the firm cannot support a complete verification. Practitioners should be aware that the AIMR-PPS standards state that “the AIMR-PPS Claim of Compliance statement can only be made on a presentation that fully adheres to the requirements of the AIMR-PPS standards.” In such situations, the practitioner should issue a statement to the investment firm clarifying why it was not possible to issue a verification report; issuance of a qualified (except for) opinion is not permitted.

.33 According to Chapter 1 of SSAE No. 10, when the practitioner is reporting on management’s assertion, the practitioner’s examination report should include an identification of the assertion and the responsible party. (When the assertion does not accompany the practitioner’s report, the first paragraph of the report should also contain a statement of the assertion.)

.34 The AIMR-PPS standards require that the report clearly indicate whether a Level I verification or a performance examination (Level II) has been performed. The AIMR-PPS standards also require that the report state the time period covered.

.35 Appendix E [paragraph .43] presents illustrative reports for a Level I verification. Appendix F [paragraph .44] presents illustrative reports for a performance examination (Level II). The reports in appendixes E [paragraph .43] and F [paragraph .44] also illustrate how the reference to a Level I verification or a performance examination (Level II), required by the AIMR-PPS standards, may be incorporated into the attest report.

.36 The AIMR-PPS standards specify that conducting a Level I verification is a condition of conducting a performance examination (Level II); the examination report on the Level I verification may be issued prior to or concurrent with the performance examination report (Level II). Practitioners who conduct performance examinations (Level II) should report both on management’s assertions about the subject matter of a Level I engagement and on the performance results of the specific composites that are the subject matter of the performance examination (Level II). The AIMR-PPS standards require that composite presentations that are the subject of a performance examination (Level II) report be attached to the report.

.37 To avoid confusion to users of the report, the practitioner should add a paragraph to a Level I report disclaiming an opinion on the performance results of any specific composites that may accompany the report (see the Level I report in appendix E [paragraph .43]). This recognizes that the practitioner cannot control whether the Level I verification report may be distributed by the investment firm as part of an AIMR-PPS standards-compliant composite presentation that has not also had a performance examination (Level II) conducted.

SOP Effective Date

.38 This SOP is effective for engagements to examine and report on aspects of an investment firm’s compliance with, and/or examining and reporting on specific composite results in conformity with, the redrafted AIMR-PPS standards, the U.S. and Canadian version of GIPS. The SOP may not be applied to engagements in which the investment firm has not yet adopted the redrafted AIMR-PPS standards.

Appendix A

AIMR-PPS Guidance for a Level I Verification

[Source: AIMR-PPS standards, Section III; www.aimr.org]

Level I verification under the AIMR-PPS standards is equivalent to GIPS verification. Therefore, all references to “the standards” below relate interchangeably to AIMR-PPS or GIPS standards. The following are the **minimum** procedures that verifiers must follow when verifying an investment firm’s claim of compliance with the standards. Verifiers must follow these procedures prior to issuing a verification report to the firm:

1. Pre-verification Procedures

- A. *Knowledge of the Firm.* Verifiers must obtain selected samples of the firm’s investment performance reports, and other available information regarding the firm, to ensure appropriate knowledge of the firm.
- B. *Knowledge of the standards.* Verifiers must understand the requirements and recommendations of the standards, including any updates, reports, or clarifications of the standards published by AIMR or the Investment Performance Council, the AIMR-sponsored body responsible for oversight of the GIPS.
- C. *Knowledge of the Performance Standards.* Verifiers must be knowledgeable of country-specific performance standards, laws, and regulations applicable to the firm, and must determine any differences between the standards and the country-specific standards, laws and regulations.
- D. *Knowledge of Firm Policies.* Verifiers must determine the firm’s assumptions and policies for establishing and maintaining compliance with all applicable requirements of the standards. At minimum, verifiers must determine the following policies and procedures of the firm:
 - i. Policy with regard to investment discretion. The verifier must receive from the firm, in writing, the firm’s definition of investment discretion and the firm’s guidelines for determining whether accounts are fully discretionary.
 - ii. Policy with regard to the definition of composites according to investment strategy; the verifier must obtain the firm’s list of composite definitions with written criteria for including accounts in each composite.
 - iii. Policy with regard to the timing of inclusion of new accounts in the composites.
 - iv. Policy with regard to timing of exclusion of closed accounts in the composites.
 - v. Policy with regard to the accrual of interest and dividend income.

- vi. Policy with regard to the market valuation of investment securities.
 - vii. Method for computing time-weighted portfolio return.
 - viii. Assumptions on the timing of capital inflows/outflows.
 - ix. Method for computing composite returns.
 - x. Policy with regard to the presentation of composite returns.
 - xi. Policies regarding timing of implied taxes due on income and realized capital gains for reporting performance on an after-tax basis.
 - xii. Policies regarding use of securities/countries not included in a composite's benchmark.
 - xiii. Use of leverage and other derivatives.
 - xiv. Any other policies and procedures relevant to performance presentation.
- E. *Knowledge of Valuation Basis for Performance Calculations.* Verifiers must ensure that they understand the methods and policies used to record valuation information for performance calculation purposes. In particular, verifiers must determine that:
- i. the firm's policy on classifying fund flows (e.g., injections, disbursements, dividends, interest, fees, taxes, etc.) is consistent with the desired results, and will give rise to accurate returns;
 - ii. the firm's accounting treatment of income, interest, and dividend receipts is consistent with cash account and cash accruals definitions;
 - iii. the firm's treatment of taxes, tax reclaims, and tax accruals is correct, and the manner used is consistent with the desired method (i.e., gross- or net-of-tax return);
 - iv. the firm's policies on recognizing purchases, sales, and the opening and closing of other positions are internally consistent and will produce accurate results; and
 - v. the firm's accounting for investments and derivatives is consistent with the standards.

2. Verification Procedures

- A. *Definition of the Firm.* Verifiers must determine that the firm is, and has been, appropriately defined.
- B. *Composite Construction.* Verifiers must be satisfied that:
 - i. the firm has defined and maintained composites according to reasonable guidelines in compliance with the standards;
 - ii. all of the firm's actual discretionary fee-paying portfolios are included in a composite;
 - iii. the manager's definition of discretion has been consistently applied over time;

- iv. at all times, all accounts are included in their respective composites and no accounts that belong in a particular composite have been excluded;
 - v. composite benchmarks are consistent with composite definitions and have been consistently applied over time;
 - vi. the firm's guidelines for creating and maintaining composites have been consistently applied; and
 - vii. the firm's list of composites is complete.
- C. *Non-Discretionary Accounts.* Verifiers must obtain a listing of all firm portfolios and determine on a sampling basis whether the manager's classification of the account as discretionary or non-discretionary is appropriate by referring to the account agreement and the manager's written guidelines for determining investment discretion.
- D. *Sample Account Selection.* Verifiers must obtain a listing of open and closed accounts for all composites for the years under examination. Verifiers may check compliance with the standards using a selected sample of a firm's accounts. Verifiers should consider the following criteria when selecting the sample accounts for examination:
- i. number of composites at the firm;
 - ii. number of portfolios in each composite;
 - iii. nature of the composite;
 - iv. total assets under management;
 - v. internal control structure at the firm (system of checks and balances in place);
 - vi. number of years under examination; and
 - vii. computer applications, software used in the construction and maintenance of composites, the use of external performance measurers and the calculation of performance results.

This list is not all-inclusive and contains only the **minimum** criteria that should be used in the selection and evaluation of a sample for testing. For example, one potentially useful approach would be to choose a portfolio for the study sample that has the largest impact on composite performance because of its size or because of extremely good or bad performance. The lack of explicit record keeping, or the presence of errors, may warrant selecting a larger sample or applying additional verification procedures.

- E. *Account Review.* For selected accounts, verifiers must determine:
- i. whether the timing of the initial inclusion in the composite is in accordance with policies of the firm;
 - ii. whether the timing of exclusion from the composite is in accordance with policies of the firm for closed accounts;
 - iii. whether the objectives set forth in the account agreement are consistent with the manager's composite definition as indicated by the account agreement, portfolio summary, and composite definition;

- iv. the existence of the accounts by tracing selected accounts from account agreements to the composites;
 - v. that all portfolios sharing the same guidelines are included in the same composite; and
 - vi. that shifts from one composite to another are consistent with the guidelines set forth by the specific account agreement or with documented guidelines of the firm's clients.
- F. *Performance Measurement Calculation.* Verifiers must determine whether the firm has computed performance in accordance with the policies and assumptions adopted by the firm and disclosed in its presentations. In doing so, verifiers should:
- i. recalculate rates of return for a sample of accounts in the firm using an acceptable return formula as prescribed by the standards (i.e., time-weighted rate of return); and
 - ii. take a reasonable sample of composite calculations to assure themselves of the accuracy of the asset weighting of returns, the geometric linking of returns to produce annual rates of returns, and the calculation of the dispersion of individual returns around the aggregate composite return.
- G. *Disclosures.* Verifiers must review a sample of composite presentations to ensure that the presentations include the information and disclosures required by the standards.
- H. *Maintenance of Records.* The verifier must maintain sufficient information to support the verification report. The verifier must obtain a representation letter from the client firm confirming major policies and any other specific representations made to the verifier during the examination.

Appendix B

AIMR-PPS Guidance for a Performance Examination (Level II)

[Source: AIMR-PPS standards, Appendix D; www.aimr.org]

With the goal to shift the focus of the industry to firmwide verification, the term “Level II verification,” which was previously an accepted form of verification under the AIMR-PPS standards, will be phased out on January 1, 2003. At that time, firms will no longer be able to state that a specific composite has been “Level II verified.” Instead, after January 1, 2003, the AIMR-PPS standards will allow firms that have received or are in the process of receiving a firmwide (Level I) verification report to have a further, more extensive performance examination or audit of a specific composite presentation. However, firms will not be able to make the claim that a particular composite has been “verified” but can claim that the composite returns have been examined or audited. The previous Level II verification procedures have been re-titled Performance Examination (Level II) and have been redrafted to focus on the need for the verifier to conduct and report a Level I verification in order to issue a Performance Examination (Level II) report. Once the term “Level II” verification is removed from the AIMR-PPS standards, “Level I” verification will simply be re-termed “verification.”

A. Scope and Purpose of Performance Examinations (Level II)

1. A Performance Examination (Level II) requires that:
 - i. The verifier follow all the verification procedures outlined for a Level I Verification and report on a Level I verification, and
 - ii. Performance results of the specific composite being examined are presented in conformity with the AIMR-PPS standards.
2. A Performance Examination (Level II) Report is issued only with respect to the composite examined by the verifier and does not attest to the accuracy of a performance presentation for any other composite.
3. After performing the Performance Examination (Level II), the verifier may conclude that the presentation does not conform to the AIMR-PPS standards or that the records of the firm cannot support the composite presentation. In such situations, the verifier should communicate to the investment management firm the reason(s) why it was not possible to provide a Performance Examination report.
4. A principal verifier may accept the work of a local or previous verifier as part of the basis for the principal verifier’s opinion.

B. Procedures for Performance Examinations (Level II)

Verifiers must conduct a Level I verification as outlined for a Level I (AIMR-PPS) verification (Section III) and issue a Level I verification report prior or concurrent to issuing a Performance Examination (Level II) report. A principal verifier may accept the work of a local

or previous verifier as part of the basis for satisfying that a firm has previously received a Level I (AIMR-PPS) verification report.

When conducting an audit of a specific composite presentation, the verifier should consider the following presumptions, bearing in mind that they are not mutually exclusive and may be subject to important exceptions:

- Evidence obtained from independent sources outside an entity provides greater assurance about the subject matter or the assertion than evidence secured solely from within the entity.
- Information obtained from the verifier's direct personal knowledge (such as through physical examination, observation, computation, operating tests, or inspection) is more persuasive than information obtained indirectly.
- The more effective the controls over the subject matter, the more assurance they provide about the subject matter or the assertion.

In performing a performance examination, the verifier's objective is to accumulate sufficient evidence to limit the risk of errors occurring and not being detected during the audit to a level that is, in the verifier's judgment, appropriately low. A verifier should select from all available procedures any combination that can limit the risk of errors occurring and not being detected during the audit to an appropriately low level.

The extent to which the examination or audit procedures will be performed should be based on the verifier's consideration of (a) the nature and materiality of the information to be tested to the subject matter or the assertion taken as a whole, (b) the likelihood of misstatements, (c) knowledge obtained during current and previous engagements, (d) the extent to which the information is affected by judgment, and (e) inadequacies in the underlying data.

When conducting a Performance Examination or audit of a specific composite presentation, the verifier must consider the following objectives.

1. **Cash Flows:** Verifiers should determine whether capital contributions and withdrawals are recorded in the proper accounts, at the right amounts and on a timely basis. The following procedures should be considered:
 - i. On a test basis, agree cash flows to appropriate supporting documentation.
 - ii. Test contributions or withdrawals of securities to ensure proper valuation and timely recording.
 - iii. Consider the reasonableness and consistent application of the methods used to account for cash flows, contributions and withdrawals.
2. **Income and Expenses:** Verifiers should determine that income and expenses are recorded in the proper accounts, at the right amounts, and on a timely basis. The following procedures should be considered:
 - i. Agree significant income and expenses to supporting documentation such as custody statements.

- ii. Evaluate the reasonableness and consistent application of the methods used to record income and expenses.
3. *Portfolio Trade Processing:* Verifiers should determine that purchases and sales of securities have been recorded in the proper accounts at the correct amounts on the appropriate dates. The following procedures should be considered:
 - i. On a test basis, agree significant trading activity to supporting documentation such as custody statements or trade tickets.
 - ii. On a test basis, agree significant end-of-period portfolio positions to supporting documentation such as custody statements.
 - iii. Evaluate the reasonableness of the portfolio trade processing system.
4. *Portfolio Valuation:* Verifiers should determine whether the end-of-period valuations of security positions are appropriate and that valuation policies are consistently applied. The following procedures should be considered:
 - i. On a test basis, agree significant end-of-period security valuations to an independent pricing source.
 - ii. On a test basis, agree significant foreign currency exchange rates to an independent pricing source.
 - iii. Evaluate the reasonableness and consistent application of the portfolio valuation methodology.
5. *Performance Measurement Calculation:* Verifiers should determine that the performance measurement statistics have been computed in accordance with the requirements contained in the AIMR-PPS standards on a consistent basis. The following procedures should be considered:
 - i. On a test basis, test the computations of account returns to ensure the use of appropriate time-weighted return calculations.
 - ii. On a test basis, test the computations of composite returns to ensure the use of appropriate size-weighted return calculations.
 - iii. Evaluate the reasonableness and consistent application of the performance measurement calculation.
6. *Other Disclosures:* Verifiers should determine whether all required disclosures have been properly presented in the performance presentation and that disclosures are appropriately supported by available documentation. The following procedures should be considered:
 - i. Evaluate whether all of the required disclosure requirements have been adequately satisfied.
 - ii. Perform tests of required disclosures as deemed necessary. These tests could involve agreeing to supporting documentation, analytical procedures, or inquiry as appropriate.
 - iii. Evaluate the reasonableness and consistent application of the disclosures.

Appendix C

Sample Engagement Letter: Level I Verification and Performance Examination (Level II)

The following is an illustration of a sample engagement letter that may be used for this kind of engagement.

[CPA Firm Letterhead]

[Client's Name and Address]

Dear _____:

This will confirm our understanding of the arrangements for our examination of management's assertions that (1) [name of company] has complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the [specify period] ending [date] and (2) the Company's processes and procedures are designed to calculate and present performance results in compliance with the AIMR-PPS standards as of [date]; this is referred to as a Level I verification under the AIMR-PPS standards. We have also been engaged to conduct an examination (referred to as a performance examination (Level II) under the AIMR-PPS standards) on the composite returns of [specify composites] of the Company for the [specify period] ending [date].

Our examination of management's assertions will be conducted in accordance with the attestation standards of the American Institute of Certified Public Accountants and with the criteria set forth in the AIMR-PPS standards. The Company is responsible for selecting the AIMR-PPS standards as the criteria against which we will evaluate its assertions and for determining that the AIMR-PPS standards are appropriate criteria for its purposes. The Company is responsible for compliance with all applicable laws, regulations, contracts, and agreements, including the AIMR-PPS standards. The Company is also responsible for the design, implementation, and monitoring of the policies and procedures upon which compliance is based.⁵ Our responsibility is to express an opinion based on our examination.

Should conditions not now anticipated preclude us from performing our examination procedures and issuing a report as contemplated by the preceding paragraph, we will advise you promptly and take such action as we deem appropriate.

Working papers that are prepared in connection with this engagement are our property. The working papers are prepared for the purpose of providing principal support for our report.

As you are aware, there are inherent limitations in the examination process, including, for example, selective testing and the possibility that collusion or forgery may preclude the detection of material errors, fraud, and illegal acts.

⁵ The independent practitioner may wish to include an understanding with the client about any limitation or other arrangements regarding liability of the practitioner or the client in the engagement letter.

Our fees will be billed as work progresses and are based on the amount of time required at various levels of responsibility plus actual out-of-pocket expenses. Invoices are payable upon presentation. We will notify you immediately of any circumstances we encounter that could significantly affect our initial estimate of total fees. The quoted fees assume that you will provide an accumulation of data for the year to be tested and that the records provided to us are clear, concise, and accurate.

In the event we are requested or authorized by Management or are required by government regulation, subpoena, or other legal process to produce our documents or our personnel as witnesses with respect to our engagement, the Company will reimburse us for our professional time and expenses, as well as any fees and expenses of our counsel, incurred in responding to such requests.

If the Company intends to use our report on the examination of the composite returns in whole or in part, or refer to [*name of CPA firm*], in connection with any sales or advertising literature, a draft of such literature will be provided to us for review and comment prior to issuance.

Pursuant to our agreement as reflected in this letter, we will examine and report on the composites selected by you until either you or we terminate this agreement.

If these arrangements are acceptable, please sign one copy of this letter and return it to us. We appreciate the opportunity to serve you.

Very Truly yours,

[*Name of CPA Firm*]

Accepted and agreed to:

[*Client Representative's Signature*]

[*Title*]

[*Date*]

Appendix D

Sample Management Representation Letter: Level I Verification and Performance Examination (Level II)

[Date]

[Name of CPA Firm]

We are providing this letter in connection with your examination(s) of the assertions of [name of company] that (1) the Company has complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, (2) the Company's processes and procedures were designed to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0, and (3) the Performance Results for Composite(s) [specify composite(s)] for the 10-year period ended December 31, 20Y0, are presented in conformity with the AIMR-PPS standards.

We confirm, to the best of our knowledge and belief, the following representations made to you during your examination(s):

1. We are responsible for (a) compliance with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (b) the design of the Company's processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards and have complied with those requirements as of December 31, 20Y0. We further confirm that we are responsible for the selection of the AIMR-PPS standards as the criteria against which you are evaluating our assertions. Further we confirm that we are responsible for determining that the AIMR-PPS standards are appropriate criteria for our purposes.
2. We assert to you that (a) we have complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (b) the Company's processes and procedures are designed to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0. We also assert that the Performance Results for ABC Composite for the 10-year period ended December 31, 20Y0, are presented in conformity with the AIMR-PPS standards.
3. We are not aware of any matters contradicting the assertions, nor have we received any communications from AIMR or regulatory agencies concerning (a) noncompliance with the AIMR-PPS standards or our assertions with regard thereto or (b) noncompliance with any other criteria relevant to investment performance statistics.
4. There has been no (a) fraud involving management or employees who have significant roles in the Company's processes and procedures relating to compliance with the AIMR-PPS standards or (b) fraud involving others that could have a material effect on the Company's compliance with the AIMR-PPS standards.

Statements of Position

5. We have made available to you all records relevant to your examination of the aforementioned assertions.
6. We acknowledge responsibility for maintaining sufficient books and records as required under Rule 204 of the Investment Advisers Act of 1940 and we have maintained such records to comply with those requirements.

We are not aware of any events that occurred subsequent to the period being reported on and through the date of this letter that would have a material effect on the aforementioned assertions.

[Name of Chief Executive Officer and Title]

[Name of Chief Financial Officer and Title]

Appendix E

Illustrative Attest Reports: Level I Verification

Example 1: Reporting on Management's Assertions

Independent Accountant's Report

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We have examined the accompanying management assertions of Ellerton Asset Management (the Company) for the 10-year period ended and as of December 31, 20Y0. These assertions are the responsibility of the Company's management. Our responsibility is to express an opinion on these assertions based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertions and performing the procedures for a Level I Verification set forth by the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards)⁶ and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertions referred to above are fairly stated, in all material respects, based on the AIMR-PPS standards.

We did not examine the performance results of the Company's composites for any period through December 31, 20Y0, including any performance presentations that may accompany this report and, accordingly, we express no opinion on any such performance results.

[Signature]

September 1, 20Y1

Example 1A: Illustrative Management's Assertions for Report Example 1

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We assert that (1) we have complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards on a firmwide basis for the 10-year period

⁶ The requirements for a Level I verification under the AIMR-PPS standards are the same as those under the GIPS standards; therefore, the practitioner may refer to the GIPS standards in an examination report on a GIPS verification, if requested.

ended December 31, 20Y0, and (2) the Company's processes and procedures are designed to calculate and present performance results in compliance with the Association for Investment Management and Research Performance Presentation Standards as of December 31, 20Y0.

[Signature]

John Q. Smith
Chief Executive Officer
Ellerton Asset Management

Example 2: Reporting Directly on the Subject Matter

Independent Accountant's Report

Ellerton Asset Management
1 Investors Square
Anywhere, USA

We have examined whether Ellerton Asset Management (the Company) (1) complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards⁷ (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0. The Company's management is responsible for compliance with the AIMR-PPS standards and the design of its processes and procedures. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Company's compliance with the above-mentioned requirements, evaluating the design of the company's processes and procedures referred to above, and performing the procedures for a Level I verification set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, Ellerton Asset Management has, in all material respects:

- Complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and
- Designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0.

We did not examine the performance results of the Company's composites for any period through December 31, 20Y0, including any performance presentations that may accompany this report and, accordingly, we express no opinion on any such performance results.

[Signature]

September 1, 20Y1

⁷ The requirements for a Level I verification under the AIMR-PPS standards are the same as those under the GIPS standards; therefore, the practitioner may refer to the GIPS standards in an examination report on a GIPS verification, if requested.

Appendix F

Illustrative Attest Reports: Level I Verification and Performance Examination (Level II)

Example I: Reporting on Management's Assertions

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined the accompanying management assertions of Atlas Asset Management (the Company) for the 10-year period ended and as of December 31, 20Y0. We have also examined management's assertion relating to the Company's ABC and XYZ Composites for the 10-year period ended December 31, 20Y0. These assertions are the responsibility of the Company's management. Our responsibility is to express an opinion on these assertions based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence supporting management's assertions and performing the procedures for a Level I verification and a performance examination (Level II) set forth by the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) and such other procedures we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, management's assertions referred to above are fairly stated, in all material respects, based on the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's ABC and XYZ Composites.

[Signature]

September 1, 20Y1

Example 1A: Illustrative Management's Assertions for Report Example I

Atlas Asset Management
10 Main Street
Anytown, USA

We assert that (1) we have complied with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) the Company's processes and procedures are designed to calculate and present performance results in compliance with the Association for Investment Management and Research Performance Presentation Standards as of December 31, 20Y0.

We also assert that the statements of performance results for the ABC and XYZ Composites for the 10-year period ended December 31, 20Y0, are presented in conformity with the Association for Investment Management and Research Performance Presentation Standards.

[Signature]

John Q. Jones
Chief Executive Officer,
Atlas Asset Management Company

Example 2: Reporting Directly on the Subject Matter (Level I and Performance Examination (Level II) Report)

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined whether Atlas Asset Management (the Company) (1) complied with all the composite construction requirements of the Association for Investment Research and Management Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0. We have also examined the accompanying [refer to title of accompanying statement] of the Company's XYZ Composite for the 10-year period ended December 31, 20Y0. The Company's management is responsible for compliance with the AIMR-PPS standards and the design of its processes and procedures and for the [refer to title of accompanying statement]. Our responsibility is to express an opinion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included examining, on a test basis, evidence about the Company's compliance with the above-mentioned requirements, evaluating the design of the company's processes and procedures referred to above, and performing the procedures for a Level I verification and a performance examination (Level II) set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, Atlas Asset Management has, in all material respects:

- Complied with all the composite construction requirements of the AIMR-PPS standards on a firmwide basis for the 10-year period ended December 31, 20Y0, and
- Designed its processes and procedures to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0.

Also, in our opinion, [refer to title of accompanying statement] of the Company's XYZ Composite for the 10-year period ended December 31, 20Y0, is presented, in all material respects, in conformity with the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's XYZ Composite.

[Signature]

September 1, 20Y1

**Example 3: Reporting Directly on the Subject Matter
(Performance Examination (Level II) Report With a Reference
to a Separate Report on a Level I Verification)**

Independent Accountant's Report

Atlas Asset Management
10 Main Street
Anytown, USA

We have examined the accompanying [refer to title of accompanying statements] of Atlas Asset Management's (the Company) ABC and XYZ Composites for the 10-year period ended December 31, 20Y0. The Company's management is responsible for these statements. Our responsibility is to express an opinion based on our examination. We previously conducted an examination (also referred to as a Level I verification) of (1) the Company's compliance with all the composite construction requirements of the Association for Investment Management and Research Performance Presentation Standards (AIMR-PPS® standards) on a firmwide basis for the 10-year period ended December 31, 20Y0, and (2) whether the Company's processes and procedures were designed to calculate and present performance results in compliance with the AIMR-PPS standards as of December 31, 20Y0; our report dated August 7, 20Y1, with respect thereto is attached.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included performing the procedures for a performance examination (Level II) set forth by the AIMR-PPS standards and such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

In our opinion, [refer to title of accompanying statements] of the Company's ABC and XYZ Composites for the 10-year period ended December 31, 20Y0, are presented, in all material respects, in conformity with the AIMR-PPS standards.

This report does not relate to any composite presentation of the Company other than the Company's ABC and XYZ Composites.

[Signature]

September 1, 20Y1

Investment Performance Statistics Task Force

JAMES S. GERSON, *Chair*
STEPHEN D. CALLAHAN
HERBERT M. CHAIN
MATT FORSTENHAUSLER
SEAN KEOGH

JESSICA MANN
PETER J. MCNAMARA
JOHN N. SPINNEY, JR.
KARYN VINCENT

AICPA Staff

CHARLES S. LANDES
Director
Audit and Attest Standards

JANE M. MANCINO
Technical Manager
Audit and Attest Standards

[The next page is 31,621.]

Section 11,390

Statement of Position 02-1 Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

May 23, 2002

NOTE

This Statement of Position (SOP) represents the recommendations of the AICPA's New Jersey Annual Claims Prompt Payment Reports Task Force regarding the application of Statements on Standards for Attestation Engagements (SSAEs) to agreed-upon procedures engagements performed to comply with the requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1 or the Code), which establishes Department of Banking and Insurance (Department) standards for the payment of claims relating to health benefits plans and dental plans and contains requirements for carriers to file certain reports with the Department relating to the timeliness of claims payments and the reasons for denial and late payment of claims in a format prescribed by the Department. The Department has approved the use of the agreed-upon procedures outlined in this SOP to comply with the reporting requirements of the Code. The Auditing Standards Board has found the recommendations in this SOP to be consistent with existing standards covered by Rule 202 of the AICPA Code of Professional Conduct. AICPA members should be aware of and consider these recommendations. If the auditor does not apply these recommendations, the auditor should be prepared to explain how he or she complied with the SSAE provisions addressed by these recommendations.

Introduction and Background

.01 New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1 or the Code), establishes Department of Banking and Insurance (Department) standards for the payment of claims relating to health benefits plans and dental plans and contains requirements for carriers to file certain reports with the Department relating to the timeliness of claims payments and the reasons for denial and late payment of claims in a format prescribed by the Department.

.02 NJAC 11:22-1 applies to any insurance company, health service corporation, medical service corporation, hospital service corporation, health maintenance organization, dental service corporation, and dental plan organization

that issues health benefits plans or dental plans in the state of New Jersey and to any agent, employee, or other representative of such entity that processes claims for such entity.

.03 Among other things, the Code requires carriers to report:

- Quarterly to the Department on the timeliness of claims payments in the format set forth in Appendix A (claims payment exhibit report) of NJAC 11:22-1, and
- Quarterly and annually on late payments of claims and the reasons for any denials (claims prompt payment report) in the format set forth in Appendix B of NJAC 11:22-1.

.04 Furthermore, the Code requires that the annual claims prompt payment report, which is due to be filed with the Department on or before March 31, pursuant to NJAC 11:22-1.9(a), be accompanied by the report of a private auditing firm, which may be a Certified Public Accountant (CPA) or a firm of CPAs. However, for calendar year 2001, the report of the private auditing firm may be filed with the Department on or before July 1, 2002. The Department has specified, in Bulletin No. 02-07, that the work shall be conducted, and the report shall be prepared, in accordance with agreed-upon procedures acceptable to the Department.

Applicability

.05 This Statement of Position (SOP) was developed to provide practitioners with guidance on performing agreed-upon procedures engagements that address annual claims prompt payment reports as required by the New Jersey Administrative Code. Practitioners should note that the engagement described in this SOP is designed only to satisfy the requirements of the Code. The procedures, as set forth in this SOP, are not necessarily appropriate for use in any other engagement.

The Code

Definitions

.06 The following definitions are reprinted from the Code and are applicable when performing the agreed-upon procedures engagement described in this SOP.

Agent—Any entity, including a subsidiary of a carrier, or an organized delivery system as defined by N.J.S.A. 17:48H-1, with which a carrier has contracted to perform claims processing or claims payment services.

Carrier—An insurance company, health service corporation, hospital service corporation, medical service corporation or health maintenance organization authorized to issue health benefits plans in this State and a dental service corporation or dental plan organization authorized to issue dental plans in this State.

Claim—A request by a covered person, a participating health care provider, or a nonparticipating health care provider who has received an assignment of benefits from the covered person, for payment relating to health care services or supplies or dental services or supplies covered under a health benefits plan or dental plan issued by a carrier.

Clean claim—

1. The claim is for a service or supply covered by the health benefits plan or dental plan;
2. The claim is submitted with all the information requested by the carrier on the claim form or in other instructions distributed to the provider or covered person;
3. The person to whom the service or supply was provided was covered by the carrier's health benefits or dental plan on the date of service;
4. The carrier does not reasonably believe that the claim has been submitted fraudulently; and
5. The claim does not require special treatment. For the purposes of this subchapter, special treatment means that unusual claim processing is required to determine whether a service or supply is covered, such as claims involving experimental treatments or newly approved medications. The circumstances requiring special treatment should be documented in the claim file.

*Covered person—*A person on whose behalf a carrier offering the plan is obligated to pay benefits or provide services pursuant to the health benefits or dental plan.

*Covered service or supply—*A service or supply provided to a covered person under a health benefits or dental plan for which the carrier is obligated to pay benefits or provides services or supplies.

*Dental plan—*A benefits plan which pays dental expense benefits or provides dental services and supplies and is delivered or issued for delivery in this State by or through any carrier in this State.

*Department—*The Department of Banking and Insurance.

*Health benefits plan—*A benefits plan that pays hospital and medical expense benefits or provides hospital and medical services, and is delivered or issued for delivery in this State by or through a carrier. Health benefits plan includes, but is not limited to, Medicare supplement coverage and risk contracts to the extent not otherwise prohibited by Federal law. For the purposes of this chapter, health benefits plan shall not include the following plans, policies or contracts: accident only, credit, disability, long-term care, CHAMPUS supplement coverage, coverage arising out of a workers' compensation or similar law, automobile medical payment insurance, personal injury protection insurance issued pursuant to P.L. 1972, c.70 (N.J.S.A. 39:6A-1 et seq.) or hospital confinement indemnity coverage.

*Health care provider or provider—*An individual or entity which, acting within the scope of its license or certification, provides a covered service or supply as defined by the health benefits or dental plan. Health care provider includes, but is not limited to, a physician, dentist and other health care professional licensed pursuant to Title 45 of the Revised Statutes and a hospital and other health care facilities licensed pursuant to Title 26 of the Revised Statutes.

Reporting Requirements

.07 The Code requires a carrier and its agent to remit payment of clean claims pursuant to specified time frames. The Code further requires that if a

carrier or its agent denies or disputes a claim, in full or in part, the carrier or its agent must, within a specified time frame, notify both the covered person when he or she will have increased responsibility for payment, and the provider, of the basis for its decision to deny or dispute the claim.

.08 The Code requires a carrier to report to the Department quarterly on the timeliness of claims payments in the format prescribed in NJAC 11:22-1, Appendix A, "New Jersey Claims Payment Exhibit." This quarterly report is not required to be subjected to an agreed-upon procedures engagement, nor is an annual claims payment exhibit report required to be filed with the Department.

.09 The Code also requires a carrier to report to the Department on a quarterly and annual basis on the late payment of claims and the reasons for denial of claims in the format prescribed in NJAC 11:22-1, Appendix B, "Quarterly (Annual) Claims Prompt Payment Report." The Code requires that the annual claims prompt payment report be accompanied by a report of a private auditing firm, which may be a CPA or a firm of CPAs.

.10 The Department has indicated, in Bulletin No. 02-07, that an agreed-upon procedures engagement pursuant to this SOP may be used to satisfy the requirement that an annual claims prompt payment report be accompanied by the report of a private auditing firm. Furthermore, in Bulletin No. 02-12, issued in May 2002, the Department has indicated that it agrees to the sufficiency of the procedures included in this SOP for its purposes.

Related Professional Standards

Chapter 2, "Agreed-Upon Procedures Engagements," of Statement on Standards for Attestation Engagements No. 10 (AT Sec. 201)

.11 Agreed-upon procedures engagements performed to meet the requirements of the Code are to be performed in accordance with Chapter 2, "Agreed-Upon Procedures Engagements," of SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 201). As described in Chapter 2 of SSAE No. 10 (AT sec. 201.03), an agreed-upon procedures engagement is one in which a practitioner is engaged by a client to issue a report of findings based on specific procedures performed on the subject matter. Not all of the provisions of Chapter 2 of SSAE No. 10 are discussed herein. Rather, this SOP includes guidance to assist practitioners in the application of selected aspects of Chapter 2 of SSAE No. 10.

.12 Chapter 2 of SSAE No. 10 (AT sec. 201.06) states, in part, that the practitioner may perform an agreed-upon procedures engagement provided that, "... (c) the practitioner and the specified parties agree upon the procedures performed or to be performed by the practitioner; and (d) the specified parties take responsibility for the sufficiency of the agreed-upon procedures for their purposes."

.13 As previously stated, Bulletin No. 02-07 from the Department states that an agreed-upon procedures engagement may be used to meet the requirement for an independent private auditing firm to report on the annual claims prompt payment reports as required by the New Jersey Administrative Code. Furthermore, the Department has approved the use of the agreed-upon procedures outlined in this SOP to comply with the reporting requirements of the

Code. Accordingly, practitioners should not eliminate any of the procedures presented in appendix B [paragraph .28], "Agreed-Up Procedures That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code," of this SOP or reduce the extent of the tests. The Department or the carrier may request that additional procedures be performed and the practitioner may agree to perform such procedures. In those circumstances, it would be expected that the additional procedures would be performed in the context of a separate agreed-upon procedures engagement.

Procedures to Be Performed

.14 The agreed-upon procedures to be performed are applied to the carrier's annual claims prompt payment report, which reports on the late payment of claims and reasons for denial of claims in the format prescribed in NJAC 11:22-1, Appendix B.

.15 The procedures to be performed in the agreed-upon procedures engagement described in this SOP are presented in appendix B [paragraph .28] of this SOP. The procedures have been designed so that the findings resulting from the application of the procedures can be recorded in a tabular format. The findings for each procedure should be reported as *No Exception*, *Exception*, or *N/A* (not applicable). If a procedure is not applicable to a particular carrier, the procedure should be marked N/A rather than deleted from the report.

.16 If any portion of a procedure results in an exception, the findings for that entire procedure should be recorded as an exception and described in the section "Description of Exceptions If Any." The practitioner should provide a brief factual explanation for each exception that will enable the specified parties to understand the nature of the findings resulting in the exception. If management informs the practitioner that the condition giving rise to the exception was corrected by the date of the practitioner's report, the practitioner's explanation of the exception may include that information; for example, "Management has advised us that the condition resulting in the exception was corrected on Month X, 20XX. We have performed no procedures with respect to management's assertion."

.17 A practitioner may perform significant portions of the agreed-upon procedures engagement before the end of the period covered by the report. If, during that time, the practitioner identifies conditions that result in an exception in one or more agreed-upon procedures, he or she should report the exception in the findings section of the agreed-upon procedures report, even if management corrects the condition prior to the end of the period.

.18 Chapter 2 of SSAE No. 10 (AT sec. 201.40) states the following:

The practitioner need not perform procedures beyond the agreed-upon procedures. However, in connection with the application of agreed-upon procedures, if matters come to the practitioner's attention by other means that significantly contradict the subject matter (or written assertion related thereto) referred to in the practitioner's report, the practitioner should include this matter in his or her report. For example, if, during the course of applying agreed-upon procedures regarding an entity's internal control, the practitioner becomes aware of a material weakness by means other than performance of the agreed-upon procedure, the practitioner should include this matter in his or her report.

.19 A practitioner has no obligation to perform procedures beyond the agreed-upon procedures included in appendix B [paragraph .28] of this SOP.

However, if information that contradicts the information in the carrier's annual claims prompt payment report comes to the practitioner's attention by other means, such information should be included in the practitioner's report. This also would apply to conditions or events occurring during the subsequent-events period (subsequent to the period covered by the practitioner's report but prior to the date of the practitioner's report) that either contradict the findings in the report or that would have resulted in the reporting of an exception by the practitioner if that condition or event had existed during the period covered by the report. However, the practitioner has no responsibility to perform any procedure to detect such conditions or events.

Establishing an Understanding With the Client

.20 In accordance with Chapter 2 of SSAE No. 10 (AT sec. 201.10), the practitioner should establish an understanding with the client regarding the services to be performed. Such an understanding reduces the risk that the client may misinterpret the objectives and limitations of an agreed-upon procedures engagement performed to meet the regulatory requirements of the Code. Such an understanding also reduces the risk that the client will misunderstand its responsibilities and the responsibilities of the practitioner. The practitioner should document the understanding in the working papers, preferably through a written communication with the client (an engagement letter). The communication should be addressed to the client. Matters that might be included in such an understanding are the following:

- A statement confirming that an agreed-upon procedures engagement is to be performed to meet the requirements of NJAC 11:22-1
- A statement identifying the procedures to be performed as those set forth in SOP 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*
- A statement identifying the client and the Department as the specified parties to the agreed-upon procedures report
- A statement acknowledging the client's responsibility for the sufficiency of the procedures in the SOP and referring to Bulletin No. 02-12, which acknowledges the Department's responsibility for the sufficiency of the procedures in the SOP
- A statement acknowledging that the practitioner makes no representation regarding the sufficiency of the procedures in the SOP
- A statement describing the responsibilities of the practitioner, including but not limited to the responsibility to perform the agreed-upon procedures and to provide the client with a report, and the circumstances under which the practitioner may decline to issue a report
- A statement indicating that the engagement will be conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants (AICPA)
- A statement indicating that an agreed-upon procedures engagement does not constitute an examination, the objective of which would be the expression of an opinion on the carrier's compliance with the requirements of NJAC 11:22-1, and that if an examination were performed, other matters might come to the practitioner's attention

- A statement indicating that the practitioner will not express an opinion or any other form of assurance
- A statement describing the client's responsibility to comply with the requirements of NJAC 11:22-1 and the client's responsibility for the information in the carrier's annual claims prompt payment report
- A statement describing the client's responsibility for providing accurate and complete information to the practitioner
- A statement indicating that the practitioner has no responsibility for the completeness or accuracy of the information provided to the practitioner
- A statement restricting the use of the report to the client and the Department
- A statement describing any arrangements to involve a specialist

Management Representations

.21 Although Chapter 2 of SSAE No. 10 does not require a practitioner to obtain a representation letter from management in an agreed-upon procedures engagement, it is recommended that the practitioner obtain such a letter when performing the engagement described in this SOP. The representation letter generally should be signed by the appropriate members of management including the highest-ranking officer responsible for the carrier's compliance with the requirements of NJAC 11:22-1. Management's refusal to furnish written representations that the practitioner has determined to be appropriate for the engagement constitutes a limitation on the performance of the engagement that requires either modification of the report or withdrawal from the engagement.

.22 The representations that a practitioner deems appropriate will depend on the specific nature of the engagement; however, the practitioner ordinarily would obtain the following representations from management:

- A statement acknowledging responsibility for compliance with the requirements of NJAC 11:22-1 and responsibility for the information in the carrier's annual claims prompt payment report
- A statement that there have been no errors or fraud that might indicate that the carrier is not in compliance with the requirements of NJAC 11:22-1 and that there are no known matters (or that management has disclosed to the practitioner all known matters) that contradict the information in the carrier's annual claims prompt payment report
- A statement that management has disclosed to the practitioner any communications from regulatory agencies relating to the carrier's annual claims prompt payment report
- A statement that management has made available to the practitioner all information it believes is relevant to the carrier's annual claims prompt payment report
- A statement that management has responded fully to all inquiries made by the practitioner during the engagement
- A statement that no events have occurred subsequent to the date as of which the procedures were applied that would require modification of the findings of the agreed-upon procedures

.23 An illustrative representation letter is presented in appendix C [paragraph .29], "Illustrative Management Representation Letter," of this SOP. For additional information regarding management's written representations in an agreed-upon procedures engagement, see Chapter 2 of SSAE No. 10 (AT sec. 201.37-.39).

Restriction on the Performance of Procedures

.24 As previously stated, a practitioner should not agree to eliminate any of the procedures presented in appendix B [paragraph .28] of this SOP. If circumstances impose restrictions on the performance of the agreed-upon procedures, the practitioner should attempt to obtain agreement from the specified users for modification of the agreed-upon procedures presented in appendix B [paragraph .28] of this SOP. When such agreement cannot be obtained, the practitioner should describe the restriction(s) on the performance of procedures in his or her report or withdraw from the engagement.

Dating the Report

.25 The date of completion of the agreed-upon procedures should be used as the date of the practitioner's report.

Effective Date

.26 This SOP is effective upon issuance and is applicable only to agreed-upon procedures engagements that report on annual claims prompt payment reports as required by the NJAC.

Appendix A

Illustrative Agreed-Upon Procedures Report

The following is an illustrative agreed-upon procedures report based on the guidance in Chapter 2, “Agreed-Upon Procedures Engagements,” of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 201).

Independent Accountant’s Report
on Applying Agreed-Upon Procedures

To the Management of ABC Carrier:

We have performed the applicable procedures enumerated in the American Institute of Certified Public Accountants’ Statement of Position (SOP) 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*, which were agreed to by ABC Carrier and the New Jersey Department of Banking and Insurance (the Department), solely to assist you in complying with the reporting requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1.9 (NJAC 11:22-1.9) for Appendix B 20XX Annual Report (Exhibit I) for the year ended December 31, 20XX. Management of ABC Carrier is responsible for compliance with the requirements of NJAC 11:22-1. This agreed-upon procedures engagement was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants. The sufficiency of these procedures is solely the responsibility of ABC Carrier and the Department. Consequently, we make no representation regarding the sufficiency of the procedures described in the attached Appendix either for the purpose for which this report has been requested or for any other purpose.

The procedures performed and the findings are included in the attached Appendix.

We were not engaged to and did not conduct an examination, the objective of which would be the expression of an opinion on ABC Carrier’s compliance with the requirements of NJAC 11:22-1 for the year ended December 31, 20XX. Accordingly, we do not express such an opinion. Had we performed additional procedures, other matters might have come to our attention that would have been reported to you.

This report is intended solely for the information and use of the management of ABC Carrier and the State of New Jersey Department of Banking and Insurance, and is not intended to be and should not be used by anyone other than these specified parties.

[Signature]

[Date]

Appendix B

Agreed-Upon Procedures That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code

<u>Procedures</u>	<u>Findings</u>		
	<u>No Exception</u>	<u>Exception</u>	<u>N/A</u>
The following procedures were applied to the ABC Carrier's 20XX Appendix B annual claims prompt payment report.			
We obtained supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report, and for each of the five categories (physician, dental, other health care professional, hospital, or other health care facilities), where applicable, compared the number of claims and the amount of claims for each quarter and the annual period from the supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report to the following columns of the report:			
• Total claims	_____	_____	_____
• Denied ineligible	_____	_____	_____
• Denied document	_____	_____	_____
• Denied coding/enrollment	_____	_____	_____
• Denied for amount	_____	_____	_____
• Time limit special	_____	_____	_____
• Time limit other	_____	_____	_____
• Denied referred fraud	_____	_____	_____
• Interest paid	_____	_____	_____
• Interest amount paid	_____	_____	_____
• Total paid	_____	_____	_____

Procedures

Findings

No
Exception Exception N/A

We selected 10 percent of the claims from ABC Carrier's supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report, with the selections distributed throughout the year. If 10 percent of the claims exceeded 50, then the number of items selected was limited to 50. If 10 percent of the claims resulted in less than 10 claims, then the number of items selected was 10, and for each item selected we:

1. Compared the following information to ABC Carrier's claim payment system:

- Paid amount _____
- Claim finalization or payment date _____
- Claim received date _____
- Denial code _____
- Claim category (physician, dental, other health care professional, hospital, or other health care facilities) _____

2. Compared the following information to the original claim information submissions:

- Date received _____
- Amount billed _____
- Category (physician, dental, other health care professional, hospital, or other health care facilities) _____

3. Noted whether, per ABC Carrier's member records, original claim information submission, or both, the claim related to a policy issued in the state of New Jersey _____

4. If a selected claim was denied, compared denial reason indicated in ABC Carrier's claims system records to supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report _____

Procedures

<u>Findings</u>		
<u>No</u>	<u>Exception</u>	<u>N/A</u>

5. If a selected claim is a "clean claim," as defined in NJAC 11:22-1.2, and as determined by ABC Carrier, recalculated the amount of interest paid on the selected claim in accordance with the requirements of NJAC 11:22-1.5

_____	_____	_____
-------	-------	-------

We selected 10 claims from ABC Carrier's primary claims system, with the selections distributed throughout the year, and for each item selected, traced the selected claims covered under New Jersey contracts to the supporting documentation used by management to prepare the Annual New Jersey Prompt Payment Report.

_____	_____	_____
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We proved the arithmetic accuracy of ABC Carrier's 20XX Appendix B annual claims prompt payment report.

_____	_____	_____
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Description of Exceptions if Any

Appendix C

Illustrative Management Representation Letter

[ABC Carrier's Letterhead]

[Date]

[CPA Firm's Name and Address]

In connection with your engagement to apply the agreed-upon procedures enumerated in the American Institute of Certified Public Accountants' Statement of Position (SOP) 02-1, *Performing Agreed-Upon Procedures Engagements That Address Annual Claims Prompt Payment Reports as Required by the New Jersey Administrative Code*, which were agreed to by ABC Carrier and the New Jersey Department of Banking and Insurance, solely to assist us in complying with the requirements of New Jersey Administrative Code, Title 11, Chapter 22, Subchapter 1 (NJAC 11:22-1.9), for Appendix B 20XX Annual Report (Exhibit I) for the period from January 1, 20XX through December 31, 20XX, we confirm, to the best of our knowledge and belief, the following representations made to you during your engagement:

1. We are responsible for compliance with the requirements of NJAC 11:22-1 and for the information in ABC Carrier's annual claims prompt payment report.
2. During the year ended December 31, 20XX, there have been no errors or fraud that would indicate that ABC Carrier is not in compliance with the requirements of NJAC 11:22-1.
3. We have disclosed to you all known matters contradicting the information in ABC Carrier's annual claims prompt payment report.
4. There have been no communications from regulatory agencies relating to ABC Carrier's annual claims prompt payment report, including communications received between December 31, 20XX, and the date of this letter.
5. We have made available to you all information that we believe is relevant to ABC Carrier's annual claims prompt payment report.
6. We have responded fully to all inquiries made to us by you during the engagement.

To the best of our knowledge and belief, no events have occurred subsequent to December 31, 20XX, and through the date of this letter that would require adjustment to or modification of the findings of the agreed-upon procedures.

[Signature]

[Title]

[Signature]

[Title]

**New Jersey Annual Claims
Prompt Payment Reports Task Force**

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CRAIG C. ANDERSON
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The AICPA is grateful to Jean Connolly, James S. Gerson, and Kim Hekker, for their technical assistance with this document.

[The next page is 50,001.]

PB Section 12,000

PRACTICE BULLETINS

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Section 12,010

Practice Bulletin 1 Purpose and Scope of AcSEC Practice Bulletins and Procedures for Their Issuance

November, 1987

NOTICE TO READERS

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants has decided to publish AcSEC Practice Bulletins to provide practitioners and preparers with guidance on narrow financial accounting and reporting issues. This bulletin presents background information on AcSEC Practice Bulletins and describes their purpose and scope and the procedures for issuing them.

Background

.02 In 1984, AcSEC established a task force to study its role. The task force recommended, among other things, that AcSEC adopt a procedure for issuing practice bulletins as a means to make its views on narrow financial and reporting issues more easily retrievable. AcSEC has previously stated its views on such issues in notices to practitioners published in the *CPA Letter* or in the *Journal of Accountancy*.

Purpose and Scope

.03 Practice bulletins are used to disseminate AcSEC's views for the purpose of providing guidance to AICPA members on narrow financial accounting and reporting issues. The guidance provided will be similar to that previously published as notices to practitioners.¹ The issues will be limited to those

¹ Previously issued notices to practitioners that continue to be relevant and applicable are listed and reprinted without change in the appendix [paragraph .09] to this practice bulletin. Other notices to practitioners are no longer relevant or applicable, as indicated in the appendix [paragraph .09].

that have not been and are not being considered by the Financial Accounting Standards Board (FASB) or the Governmental Accounting Standards Board (GASB). The purpose of practice bulletins is to enhance the quality and comparability of financial statements.

Procedures for Publication

.04 Drafts of practice bulletins are discussed in open meetings of AcSEC and are available to the public as part of the agenda papers for such meetings. Practice bulletins need not be exposed for comment and are not the subject of public hearings.

.05 A practice bulletin may be published only if—

- a.* Two-thirds of AcSEC approve publication.
- b.* The FASB and GASB have had the opportunity to review it, and each of those bodies has informed AcSEC that it has no current plans to consider the issue.

.06 The procedures for issuing amendments of practice bulletins are the same as the procedures for issuing original practice bulletins.

.07 Once a practice bulletin has been approved for issuance, it is distributed to all practice units and other interested parties. The bulletin includes a notice to readers that indicates that—

- a.* AcSEC is the issuing body.
- b.* The document is not covered by rule 203 of the AICPA Code of Conduct.

.08 Practice bulletins will be numbered to facilitate reference and retrievability.

.09

Appendix

The following notices to practitioners, first published in the *CPA Letter*, are still relevant and are reprinted in this appendix (exhibits A through I).

<u>Title</u>	<u>Date Published</u>	<u>Exhibit</u>
<i>ACRS Lives and GAAP</i>	11/23/81	A
<i>Accounting by Colleges and Universities for Compensated Absences</i>	9/13/82	B
<i>ADC Arrangements</i>	2/10/86	I

The following notices to practitioners published in the *CPA Letter* or in the *Journal of Accountancy* are no longer relevant or applicable.

<u>Title</u>	<u>Date Published</u>	<u>Comments</u>
<i>Fee Regulations</i>	3/10/80*	FASB Statement No. 91, <i>Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans</i> , now provides authoritative guidance.
<i>Accounting for Combinations of Mutual Savings and Loan Associations or Mutual Savings Banks</i>	1/11/82*	FASB Statement No. 72, <i>Accounting for Certain Acquisitions of Banking or Thrift Institutions</i> , now provides authoritative guidance.
<i>Mortgage Banking Activities</i>	6/27/83*	Superseded by the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.
<i>Interest as a Holding Cost</i>	10/10/83*	Superseded by the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.
<i>Certain Real Estate Lending Activities of Financial Institutions</i>	11/83†	Superseded by the 2/10/86 notice on accounting for real estate acquisition, development, and construction (ADC) arrangements.
<i>Allowance for Loan Losses, Insider Loans, and Loan Participations</i>	12/12/83*	The October 1986 Auditing Procedure Study, <i>Auditing the Allowance for Credit Losses of Banks</i> , now provides guidance.

* Published in the *CPA Letter*.

† Published in the *Journal of Accountancy*.

<u>Title</u>	<u>Date Published</u>	<u>Comments</u>
<i>Bank Loan Disclosures</i>	12/26/83*	Superseded by the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.
<i>Accounting and Disclosures for Reinsurance Transactions</i>	1/23/84*	Effectively superseded by FASB Statement No. 113, <i>Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts</i> .
<i>Accounting and Disclosure for Income Taxes of Stock Life Insurance Companies in 1983 Financial Statements</i>	1/23/84*	Applied only to financial statements in 1983.
<i>Loan Origination Fees</i>	9/24/84*	FASB Statement No. 91, <i>Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans</i> , now provides authoritative guidance.
<i>Deposit Float</i>	9/24/84*	Superseded by and incorporated into the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.
<i>ADC Loans</i>	11/26/84*	Superseded by the 2/10/86 notice on ADC arrangements.
<i>Accounting for Foreign Loan Swaps</i>	5/27/85*	Superseded by and incorporated into the AICPA Audit and Accounting Guide <i>Banks and Savings Institutions</i> , 1996.

* Published in the *CPA Letter*.

Exhibit A

ACRS Lives and GAAP*

The Economic Recovery Tax Act of 1981 established the Accelerated Cost Recovery System (ACRS), which replaces the depreciation system for income tax purposes. ACRS eliminates for income taxes the need to select a depreciation method and to determine each asset's useful life and salvage value. Instead of depreciation deductions permitted by prior tax laws, enterprises must now use recovery deductions in determining taxable income. The recovery deductions are determined by applying percentages specified by the law to the tax basis of the asset for a specified number of years.

The Institute's accounting standards executive committee has been asked whether the recovery deductions used for income tax purposes also may be used as depreciation expense for financial reporting.

Generally accepted accounting principles require that the cost of depreciable assets be allocated to expense over the expected useful life of the asset in a systematic and rational manner. In contrast, the recovery deductions required under ACRS were designed to encourage investment in productive assets by allowing accelerated deduction of the tax basis of an asset.

If the number of years specified by ACRS for recovery deductions for an asset does not fall within a reasonable range of the asset's useful life, the recovery deductions should not be used as depreciation expense for financial reporting. Depreciation expense in financial statements for such an asset should be determined based on the asset's useful life.

If the recovery deductions for income tax purposes differ from depreciation expense for financial reporting, deferred income taxes should be provided in financial statements for the temporary differences that result, as required by FASB Statement No. 109, *Accounting for Income Taxes*. [Revised, April 1996, to reflect the conforming changes necessary due to the issuance of recent authoritative literature.]

* Reprinted from the *CPA Letter*, November 23, 1981.

Exhibit B

Accounting by Colleges and Universities for Compensated Absences*

FASB Statement of Financial Accounting Standards No. 43, *Accounting for Compensated Absences*, requires an employer to accrue a liability for employees' rights to receive compensation for future absences if certain conditions are met. The National Association of College and University Business Officers (NACUBO) asked the FASB to defer the applicability for Statement No. 43 to colleges and universities, which use fund accounting, until fund accounting questions have been resolved.

The board decided not to defer the applicability of Statement No. 43 to colleges and universities and indicated that the statement applies to institutions covered by the AICPA industry audit guide, *Audits of Colleges and Universities*. The audit guide states that it covers "nonprofit institutions of higher education including colleges, universities, community or junior colleges." Such an institution therefore should accrue a liability for compensated absences in accordance with Statement No. 43 following the guidance in this announcement.

AICPA members have recently asked several questions on how to apply Statement No. 43 to institutions covered by the audit guide, especially how to account for the charge when the liability is first recorded. Confusion has resulted from the publication of articles indicating that institutions were recording the liability directly in their plant funds. Research does not reveal any case in which that treatment has been followed.

Although the audit guide was published before Statement No. 43 was issued and therefore does not refer specifically to the application of the statement to those institutions, the audit guide can provide guidance on the questions.

The accounting standards executive committee recently discussed the problem and makes these observations to clarify the application of Statement No. 43 within the guidance provided by the audit guide:

- The liability and charge for compensated absences related to current and previous years should be recorded in the unrestricted current fund.
- Neither the liability nor the charge should be recorded in the plant funds.
- There has been some question as to whether a receivable and related revenue could be recorded for the portion of the liability expected to be paid from present or future state appropriations or grants and contracts for sponsored research and training programs. A receivable and related revenue should be recognized only if the receivable meets the definition of an asset in FASB Statement of Financial Accounting Concepts No. 3, *Elements of Financial Statements of Business Enterprises*. In applying the definition, the college or university should consider factors such as measurability, collectibility and legal rights and should look, for example, to entitlements under state constitutions or contracts with the federal government.

* Reprinted from the *CPA Letter*, September 13, 1982.

- The effect of the charge on the unrestricted current fund balance caused by recognition of such a liability may be offset in whole or in part by interfund transfers resulting in a receivable in the unrestricted current fund only if (1) unrestricted assets are available for permanent transfer and (2) payment (or settlement by other means) to the unrestricted current fund is expected within a reasonable period of time.



50,028

Practice Bulletins

Exhibit C

Mortgage Banking Activities^[*]

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[*] [Footnote deleted.]

Exhibit D

Interest as a Holding Cost^[*]

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[*] [Footnote deleted.]

50,030

Practice Bulletins

Exhibit E

Bank Loan Disclosures^[*]

[Superseded by the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

^[*] [Footnote deleted.]

Exhibit F

Accounting and Disclosures for Reinsurance Transactions^[*]

[Effectively superseded by FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts.*]

^[*] [Footnote deleted.]

50,032

Practice Bulletins

Exhibit G

Deposit Float^[*]

[Superseded by and incorporated into the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

^[*] [Footnote deleted.]

Exhibit H

Accounting for Foreign Loan Swaps^[*]

[Superseded by and incorporated into the AICPA Audit and Accounting Guide *Banks and Savings Institutions*, 1996.]

[*] [Footnote deleted.]

Exhibit I

ADC Arrangement*

The AICPA accounting standards executive committee (AcSEC) has prepared the following guidance on accounting for real estate acquisition, development, or construction (ADC) arrangements of financial institutions. This guidance is intended to clarify and expand upon the two Notices to Practitioners issued in November 1983 and November 1984 on this subject; accordingly, it supersedes those notices. Because practice and guidance on this matter have been the subject of debate and evolution over time, the guidance contained in this notice should be applied to ADC arrangements entered into after its issuance.

1. Financial institutions may enter into ADC arrangements in which they have virtually the same risks and potential rewards as those of owners or joint venturers. AcSEC believes that, in some instances, accounting for such arrangements as loans would not be appropriate and thus is providing this guidance in determining the proper accounting.

Scope

2. This notice applies only to those ADC arrangements in which the lender participates in *expected residual profit*, as further described below.

Expected Residual Profit

3. Expected residual profit is the amount of profit, whether called interest or another name, such as equity kicker, above a reasonable amount of interest and fees expected to be earned by the lender.

4. The extent of such profit participation and its forms may vary. An example of a simple form might be one in which the contractual interest and fees, if any, on a condominium project are considered to be at fair market rates; the expected sales prices are sufficient to cover at least principal, interest, and fees; and the lender shares in an agreed proportion, for example, 20 percent, 50 percent, or 90 percent, of any profit on sale of the units.

5. A slightly different form of arrangement may produce approximately the same result. For example, the interest rate and/or fees may be set at a level higher than in the preceding example, and the lender may receive a smaller percentage of any profit on sale of the units. Thus, a greater portion of the expected sales price is required to cover the contractual interest and/or fees, leaving a smaller amount to be allocated between the lender and the borrower. The lender's share of expected residual profit in such an arrangement may be approximately the same as in the preceding example. A different arrangement may cause the same result if the interest rate and/or fees are set at a sufficiently high level and the lender does not share in any proportion of profit on sale of the units. Another variation is one in which the lender shares in gross rents or net cash flow from a commercial project, for example, an office building or an apartment complex.

6. The profit participation agreement may or may not be part of the mortgage loan agreement. Consequently, the auditor should be aware of the

* Reprinted from the *CPA Letter, Special Supplement*, February 10, 1986.

possibility that such agreements may exist and should design audit procedures accordingly. Those procedures could include inquiries to, and requests for written representation from, both the lender and the borrower.

7. The accounting guidance in paragraphs 16 and 17 is based on a consideration of the following characteristics of ADC arrangements. A particular ADC arrangement may have one or more of these characteristics.

Characteristics of ADC Arrangements Implying Investments in Real Estate or Joint Ventures

8. As stated in the "Scope" section, this notice applies to an ADC arrangement in which the lender participates in expected residual profit. In addition to the lender's participation in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with an investment in real estate or joint venture:

- a. The financial institution agrees to provide all or substantially all necessary funds to acquire, develop, or construct the property. The borrower has title to but little or no equity in the underlying property.
- b. The financial institution funds the commitment or origination fees or both by including them in the amount of the loan.
- c. The financial institution funds all or substantially all interest and fees during the term of the loan by adding them to the loan balance.
- d. The financial institution's only security is the ADC project. The financial institution has no recourse to other assets of the borrower, and the borrower does not guarantee the debt.
- e. In order for the financial institution to recover the investment in the project, the property must be sold to independent third parties, the borrower must obtain refinancing from another source, or the property must be placed in service and generate sufficient net cash flow to service debt principal and interest.
- f. The arrangement is structured so that foreclosure during the project's development as a result of delinquency is unlikely because the borrower is not required to make any payments until the project is complete, and, therefore, the loan normally cannot become delinquent.

Characteristics of ADC Arrangements Implying Loans

9. Even though the lender participates in expected residual profit, the following characteristics suggest that the risks and rewards of an ADC arrangement are similar to those associated with a loan:

- a. The lender participates in less than a majority of the expected residual profit.
- b. The borrower has an equity investment, substantial to the project, not funded by the lender. The investment may be in the form of cash payments by the borrower or contribution by the borrower of land (without considering value expected to be added by future development or construction) or other assets. The value attributed to the land or other assets should be net of encumbrances. There may be little value to assets with substantial prior liens that make foreclosure to collect less likely. Recently acquired property generally should be valued at no higher than cost.

- c. The lender has 1) recourse to substantial tangible, saleable assets of the borrower, with a determinable sales value, other than the ADC project that are not pledged as collateral under other loans; or 2) the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan.
- d. A take-out commitment for the full amount of the financial institution's loans has been obtained from a creditworthy, independent third party. Take-out commitments often are conditional. If so, the conditions should be reasonable and their attainment probable.
- e. Noncancelable sales contracts or lease commitments from creditworthy, independent third parties are currently in effect that will provide sufficient net cash flow on completion of the project to service normal loan amortization, that is, principal and interest. Any associated conditions should be probable of attainment.

Personal Guarantees

10. Some ADC arrangements include personal guarantees of the borrower and/or a third party. AcSEC believes that the existence of a personal guarantee alone rarely provides a sufficient basis for concluding that an ADC arrangement should be accounted for as a loan. In instances where the substance of the guarantee and the ability of the guarantor to perform can be reliably measured, and the guarantee covers a substantial amount of the loan, concluding that an ADC arrangement supported by a personal guarantee should be accounted for as a loan may be justified.

11. The substance of a personal guarantee depends on a) the ability of the guarantor to perform under the guarantee, b) the practicality of enforcing the guarantee in the applicable jurisdiction, and c) a demonstrated intent to enforce the guarantee.

12. Examples of personal guarantees that have the ability to perform would include those supported by liquid assets placed in escrow, pledged marketable securities, or irrevocable letters of credit from a creditworthy, independent third party[ies] in amounts sufficient to provide necessary equity support for an ADC arrangement to be considered a loan. In the absence of such support for the guarantee, the financial statements and other information of the guarantor may be considered to determine the guarantor's ability to perform. Due to the high-risk nature of many ADC arrangements, AcSEC believes financial statements that are current, complete, and include appropriate disclosures and that are reviewed or audited by independent CPAs are the most helpful in this determination.

13. Particular emphasis should be placed on the following factors when considering the financial statements of the guarantor:

- a. *Liquidity as well as net worth of the guarantor*—There should be evidence of sufficient liquidity to perform under the guarantee. There may be little substance to a personal guarantee if the guarantor's net worth consists primarily of assets pledged to secure other debt.
- b. *Guarantees provided by the guarantor to other projects*—If the financial statements do not disclose and quantify such information, inquir-

ies should be made as to other guarantees. Also, it may be appropriate to obtain written representation from the guarantor regarding other contingent liabilities.

14. The enforceability of the guarantee in the applicable jurisdiction should also be determined. Even if the guarantee is legally enforceable, business reasons that might preclude the financial institution from pursuing the guarantee should be assessed. Those business reasons could include the length of time required to enforce a personal guarantee, whether it is normal business practice in that jurisdiction to enforce guarantees on similar transactions, and whether the lender must choose between pursuing the guarantee or the project's assets, but cannot pursue both. The auditor should consider obtaining written representation from management regarding its intent to enforce personal guarantees.

Sweat Equity

15. Some ADC arrangements recognize value, not funded by the lender, for the builder's efforts after inception of the arrangement, sometimes referred to as *sweat equity*. AcSEC believes that sweat equity is not at risk by the borrower at the inception of an ADC project. Consequently, AcSEC believes sweat equity should not be considered a substantial equity investment on the part of the borrower in determining whether the ADC arrangement should be treated as a loan.

Accounting Guidance

16. In the interest of more uniformity in accounting for ADC arrangements, AcSEC believes the following guidance is appropriate:

- a. If the lender is expected to receive over 50 percent of the expected residual profit, as previously defined, from the project, the lender should account for income or loss from the arrangement as a real estate investment as specified by Statement of Financial Accounting Standards (SFAS) No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects*,¹ and SFAS No. 66, *Accounting for Sales of Real Estate*.²
- b. If the lender is expected to receive 50 percent or less of the expected residual profit, the entire arrangement should be accounted for either as a loan or as a real estate joint venture, depending on the circumstances. At least one of the characteristics identified in paragraph 9, b through e, or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate.
 1. In the case of a loan, interest and fees may be appropriately recognized as income subject to recoverability. Statement of Position (SOP) No. 75-2, *Accounting Practices of Real Estate Investment Trusts*,³ and the AICPA Audit and Accounting Guide en-

¹ Statement of Financial Accounting Standards (SFAS) No. 67, *Accounting for Costs and Initial Rental Operations of Real Estate Projects* (Stamford: FASB, 1982).

² SFAS No. 66, *Accounting for Sales of Real Estate* (Stamford: FASB, 1982).

³ Statement of Position (SOP) No. 75-2, *Accounting Practices of Real Estate Investment Trusts* (New York: AICPA, 1975).

titled, *Banks and Savings Institutions*,^[4] provide guidance that may be relevant in those industries in assessing the recoverability of such loan amounts and accrued interest.

2. In the case of a real estate joint venture, the provisions of SOP No. 78-9, *Accounting for Investments in Real Estate Ventures*,⁵ and SFAS No. 34, *Capitalization of Interest Cost*,⁶ as amended by SFAS No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method*,⁷ provide guidance for such accounting. In particular, paragraph 34 of SOP No. 78-9 provides guidance on the circumstances under which interest income should not be recognized.

17. ADC arrangements accounted for as investments in real estate or joint ventures should be combined and reported in the balance sheet separately from those ADC arrangements accounted for as loans.

Other Considerations

18. Transactions have occurred in which the lender's share of the expected residual profit in a project is sold to the borrower or a third party for cash or other consideration. If the expected residual profit in an ADC arrangement accounted for as a loan is sold, AcSEC believes the proceeds from the sale should be recognized prospectively as additional interest over the remaining term of the loan. The expected residual profit is considered additional compensation to the lender, and the sale results in a quantification of the profit. When an ADC arrangement is accounted for as an investment in real estate or joint venture and the expected residual profit is sold, gain recognition, if any, is appropriate only if the criteria of SFAS No. 66 are met after giving consideration to the entire ADC arrangement including the continuing relationship between the financial institution and the project.

19. If the financial institution was the seller of the property at the initiation of the project, gain recognition, if any, should be determined by reference to SFAS No. 66.

20. The factors that were evaluated in determining the accounting treatment at inception subsequently change for some ADC arrangements, for example, as a result of a renegotiation of the terms. Consequently, the accounting treatment for an ADC arrangement should be periodically reassessed. An ADC arrangement originally classified as an investment or joint venture could subsequently be treated as a loan if the risk to the lender diminishes significantly, and the lender will not be receiving over 50 percent of the expected residual profit in the project. The lender must demonstrate a change in the facts relied upon when initially making the accounting decision, not just the absence of, or reduced participation in, the expected residual profit. For instance, risk may be reduced if a valid take-out commitment from another lender who has the capability to perform under the commitment is obtained and all conditions affecting the take-out have been met, thus assuring the primary lender recovery

^[4] [Footnote deleted.]

⁵ SOP No. 78-9, *Accounting for Investments in Real Estate Ventures* (New York: AICPA, 1978).

⁶ SFAS No. 34, *Capitalization of Interest Cost* (Stamford: FASB, 1979).

⁷ SFAS No. 58, *Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method* (Stamford: FASB, 1982).

of its funds. If the lender on the other hand assumes further risks and/or rewards in an ADC arrangement by, for example, releasing collateral supporting a guarantee and/or increasing its percentage of profit participation to over 50 percent, the lender's position may change to that of an investor in real estate. Neither an improvement in the economic prospects for the project or successful, on-going development of the project nor a deterioration in the economic prospects for the project justifies a change in classification of an ADC arrangement. A change in classification is expected to occur infrequently and should be supported by appropriate documentation. The change in factors in an ADC arrangement should be evaluated based on the guidance in this notice and accounted for prospectively.

21. If an ADC arrangement accounted for as a real estate joint venture continues into a permanent phase with the project generating a positive cash flow and paying debt service currently, income should be recognized in accordance with SOP No. 78-9.

22. Regardless of the accounting treatment for an ADC arrangement, management has a continuing responsibility to review the collectibility of uncollected principal, accrued interest, and fees and provide for appropriate allowances. The auditor should determine whether the allowances provided by management are adequate. In connection with this determination, the auditor should review relevant evidential matter including feasibility studies, appraisals, forecasts, non-cancelable sales contracts or lease commitments and information concerning the track record of the developer. In addition, ADC arrangements may involve related parties and the auditor should be aware of such a possibility and design procedures accordingly. Progress information may be less than desirable for the auditor's purpose and may require supplemental procedures. Additional procedures might include on-site inspection of projects or the independent use of experts such as property appraisers or construction consultants to assist in the assessment of the collateral value.

23. Many participations in loans or whole loans are bought and sold by other financial institutions. The accounting treatment for a purchase that involves ADC arrangements should be based on a review of the transaction at the time of purchase in accordance with the guidance in this notice. In applying this guidance, a participant would look to its individual percentage of expected residual profit; for example, a participant who will not share in any of the expected residual profit is not subject to this notice. However, the responsibility to review collectibility and provide allowances applies equally to purchased ADC arrangements. Any reciprocal transactions between institutions, including multi-party transactions, should be viewed in their entirety and accounted for in accordance with their combined effects.

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Section 12,020**Practice Bulletin 2
Elimination of Profits Resulting From
Intercompany Transfers of LIFO Inventories**

November, 1987

NOTICE TO READERS

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee (AcSEC) believes it is desirable to issue a reminder concerning inventory transfers between or from LIFO (last in, first out) pools, either within a company or between subsidiaries or divisions of a reporting entity, particularly if a LIFO inventory liquidation has occurred in any transferring LIFO pool during the year.¹

.02 A LIFO liquidation (also called a decrement) occurs when the number of units (or total base year cost if dollar value LIFO is used) in a LIFO pool at year end is less than that at the beginning of the year, causing prior years' costs, rather than current year's costs, to be charged to current year's income. For example, in periods of rising prices, prior years' costs are less than current year's costs and, in such periods, charging prior years' costs to current year's income results in reporting current year's net income higher than it would be reported without a liquidation.

.03 Accounting for a LIFO liquidation is more complex with intercompany transfers of inventories. Accounting Research Bulletin (ARB) 51, *Consolidated Financial Statements*, states that "the purpose of consolidated financial statements is to present . . . the results of operations and the financial position of the parent company and its subsidiaries essentially as if the group were a single company with one or more branches." Under ARB 51, intercompany pro-

¹ This subject was identified in paragraph 3-2 of AcSEC's November 30, 1984, issues paper, *Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories*.

fit on assets remaining within the group should be eliminated.² Results of operations and financial position, therefore, should not be affected solely because of inventory transfers within a reporting entity. Inventory transferred between or from LIFO pools may cause LIFO inventory liquidations which could affect the amount of intercompany profit to be eliminated.

.04 Many different approaches are used by entities in eliminating such profit. AcSEC believes that each reporting entity should adopt an approach that, if consistently applied, defers reporting intercompany profits from transfers within a reporting entity until such profits are realized by the reporting entity through dispositions outside the consolidated group. The approach should be suited to the entity's individual circumstances.

² APB Opinion 18, *The Equity Method of Accounting for Investments in Common Stock*, also requires elimination of a portion of intercompany profit.

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Section 12,040**Practice Bulletin 4
Accounting for Foreign Debt/Equity Swaps**

May, 1988

NOTICE TO READERS

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under Rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 The Accounting Standards Executive Committee and the Banking Committee of the American Institute of Certified Public Accountants (AICPA) have considered the accounting treatment by financial institutions for exchanges of their public or private sector loans to debtors in financially troubled countries for equity investments in companies in the same countries. These transactions are generally referred to as *debt/equity swaps*. As a result of these deliberations, the committees have prepared the following guidance, based on existing authoritative accounting literature, for financial institutions and independent auditors.

.02 Debt/equity swap programs are in place in several financially troubled countries. Although the programs differ somewhat among the countries, the principal elements of each program generally are as follows. Holders of U.S. dollar-denominated debt of these countries can choose to convert that debt into approved local equity investments. The holders are credited with local currency, at the official exchange rate, approximately equal to the U.S. dollar debt. A discount from the official exchange rate is usually imposed as a transaction fee. The local currency credited to the holder must be used for an approved equity investment. The local currency is not available to the holders for any other purpose. Dividends on the equity investment can generally be paid annually, although there may be restrictions on the amounts of the dividends or on payment of dividends in the early years of the investment. Capital usually cannot be repatriated for several years, and although some countries permit the investment to be sold, the proceeds from any such sale are generally subject to similar repatriation restrictions.

.03 A debt/equity swap is an exchange transaction of a monetary for a nonmonetary asset, which should be measured at fair value at the date the transaction is agreed to by both parties. (See paragraph .11 for a discussion of loss recoveries or gains.)

.04 There is a significant amount of precedent in the accounting for exchange transactions to consider both the fair value of the consideration given up as well as the fair value of the assets received in arriving at the most informed valuation—especially if the value of the consideration given up is not readily determinable or may not be a good indicator of the value received. For example, in acquisitions involving consideration in the form of stock, an examination of the value of the net assets received is often considered necessary if the stock is thinly traded or restricted.

.05 APB Opinion 16, *Business Combinations*, deals with the acquisition of assets (paragraph 67) and with determining the cost of an acquired company (paragraphs 72-75). In summary, paragraph 67 states that assets acquired should be recorded based on the fair value of assets exchanged, liabilities incurred, or stock issued, unless the fair value of the assets received is more clearly determinable (“cost may be determined either by fair value of consideration given up or by fair value of property acquired, whichever is the more clearly evident”). Paragraph 72 states that the same accounting principles apply to determining the cost of assets acquired individually, those acquired in a group, and those acquired in business combinations. APB Opinion 29, *Accounting for Nonmonetary Transactions*, paragraph 18, provides similar guidance.

.06 FASB Statement No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructurings*, deals with the receipt of assets in satisfaction of a loan and, in paragraph 28, states that a creditor shall account for assets received (including an equity interest) at their fair value at the time of the restructuring, unless the fair value of the receivable satisfied is more clearly evident.

.07 Debt/equity swaps have characteristics similar to both the acquisition of assets contemplated by APB Opinions 16 and 29 and the receipt of assets in satisfaction of a loan contemplated by FASB Statement No. 15. Since the secondary market for debt of financially troubled countries is presently considered to be thin, it may not be the best indicator of the value of the equity investment or of net assets received. In light of this thin secondary market and of the unique nature of the transaction, it is also necessary to examine the value of the equity investment or net assets received. The committees therefore believe that in arriving at the fair value of a debt/equity swap, both the secondary market price of the loan given up and the fair value of the equity investment or net assets received should be considered. It is the responsibility of management to make the valuation considering all of the circumstances. It is the responsibility of independent auditors to become satisfied that the valuation is based on reasonable methods and assumptions, including, as needed, information from independent appraisals. Factors to consider in determining current fair values include the following:

- Similar transactions for cash
- Estimated cash flows from the equity investment or net assets received
- Market value, if any, of similar equity investments
- Currency restrictions, if any, affecting dividends, the sale of the investment, or the repatriation of capital

.08 In accordance with generally accepted accounting principles, a financial institution's loan portfolio should be carried at amortized historical cost less both loan write-offs and the allowance for loan losses, as long as the financial institution has the ability and intent to hold the loans until their maturity. Management may decide to dispose (by sale of swap) of loans prior to maturity for a number of reasons, including liquidity needs, tax considerations, portfolio diversification objectives, and management practices of generating loans specifically for disposition, in which case the loans should be carried at the lower of cost (amortized historical cost less loan write-offs) or fair value.

.09 If the fair value of the equity investment or net assets received in a debt/equity swap is less than the recorded investment in the loan, the committees believe that a loss should be recognized and recorded at the date the transaction is agreed to by both parties. Although some portion of the swap loss may result from factors such as a change in the interest rate environment for similar loans, the committees believe that the loss results principally from a concern as to the ultimate collectibility of the loan. Therefore, the swap loss generally should be charged to the allowance for loan losses and should include any discounts from the official exchange rate that are imposed as a transaction fee.

.10 All other fees and transaction costs involved in a debt/equity swap should not be capitalized but should be charged to expense as incurred.

.11 Loss recoveries or even gains might be indicated in a swap transaction as a result of the valuation process. However, due to the subjective nature of the valuation process, the committees believe that such loss recoveries or gains ordinarily should not be recorded until the equity investment or net assets received in the swap transaction are realized in unrestricted cash or cash equivalents.

.12 In addition to recording specific transactions during an accounting period, a financial institution, in the course of preparing its financial statements, should review its loan portfolio in order to assess the adequacy of the allowance for loan losses. Allowances are established and write-offs taken based on management's judgment regarding ultimate collectibility of the loans in the normal course of business. Recognition of a debt/equity swap loss should be among the factors to be considered by management in its periodic assessment of the adequacy of the allowance for loan losses with respect to its remaining portfolio of loans to debtors in financially troubled countries.

.13 The committees recommend that the guidance in this practice bulletin be adopted upon issuance.

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Section 12,050

Practice Bulletin 5 Income Recognition on Loans to Financially Troubled Countries

July, 1988

NOTICE TO READERS

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.01 Loans to financially troubled countries (LDC loans) of many banks currently meet the conditions in paragraph 8 of FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, for accrual of loss contingencies. As a result, those banks should have established loan loss allowances for their LDC loans by charges to income.

.02 A financially troubled country may suspend the payment of interest on its loans. Banks with outstanding loans from such a country have also suspended accrual of interest income (placed them on nonaccrual status).

.03 A country that has suspended payment of interest may later resume payment. Guidance on accounting by a creditor for the receipt of interest payments from a debtor that had previously suspended payment, on pages 51 and 52 in the industry audit guide *Audits of Banks* (2nd ed. [1983]) published by the Institute, is as follows:

Many banks suspend accrual of interest income on loans when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory reporting guidelines for nonaccrual loans have been established by federal supervisory agencies.

Although placing a loan in a nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

.04 At issue is whether this guidance means that the creditor should credit receipt of renewed interest payments to the principal balance of the loan or to income.

Interpretation

.05 The Accounting Standards Executive Committee and the Committee on Banking agree on the interpretation of that section of the guide as set forth in paragraph .07 of this practice bulletin.

[.06] [Effectively superseded by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan.*]

.07 When a country becomes current as to principal and interest payments and has normalized relations with the international financial community including, as appropriate, having in place an understanding with the International Monetary Fund regarding its economic stabilization program, and assuming that the allowance for loan losses is adequate, the creditor may recognize receipt of interest payments as income.

.08 Although a country has met the conditions described in paragraph .07, that should not automatically lead to the conclusion that the loans should be returned to accrual status. Some period of payment performance generally is necessary in order to make an assessment of collectibility that would permit returning the loans to accrual status.

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Section 12,060**Practice Bulletin 6
Amortization of Discounts on Certain
Acquired Loans**

August, 1989

NOTICE TO READERS

Practice Bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

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.01 The Accounting Standards Executive Committee (AcSEC) has prepared the following guidance, based on existing authoritative literature, regarding amortization of discounts on certain acquired loans for which there is uncertainty as to the amounts or timing of future cash flows.

Scope

.02 This practice bulletin addresses the accounting and reporting by purchasers of loans (1) that are acquired in a purchase business combination, bought at a discount from face value in a transaction other than a business combination, or transferred to a newly created subsidiary after having been written down to fair value with the intent of transferring the stock of the subsidiary as a dividend to the shareholders of the parent company and (2) for which it is not probable that the undiscounted future cash collections will be sufficient to recover the face amount of the loan and contractual interest.

.03 This practice bulletin applies to loans and other debt securities, such as corporate or governmental bonds, notes, and loan-backed securities, such as pass-through certificates, collateralized mortgage obligations, and other so-called securitized loans. For convenience, those other debt securities are hereinafter referred to as *loans*. It does not apply to loans that are carried at market values or at the lower of cost or market, nor does it apply to loans held by liquidating banks.¹ Enterprises that acquire loans primarily for the rewards of ownership of the underlying nonmonetary collateral should record the collateral rather than the loan. Accordingly, this practice bulletin does not apply

¹ Financial reporting by liquidating banks is dealt with in the minutes of the FASB's Emerging Issues Task Force for Issue 88-25, "Ongoing Accounting and Reporting for a Newly Created Liquidating Bank."

to such transactions. SEC Financial Reporting Release No. 28, *Accounting for Loan Losses by Registrants Engaged in Lending Activities*, and the February 10, 1986, notice to practitioners on ADC arrangements, reprinted in AcSEC Practice Bulletin 1 [section 12,010], may be helpful in determining whether a loan was acquired for that purpose.

Background

.04 Loans may be acquired at discounts from their face amounts. The discounts normally are amortized with corresponding increases in income over the estimated or contractual lives of the loans. APB Opinion 21, *Interest on Receivables and Payables*, describes the accounting for originated loans:

Note received or issued for cash. The total amount of interest during the entire period of a cash loan is generally measured by the difference between the actual amount of cash received by the borrower and the total amount agreed to be repaid to the lender. Frequently, the stated or coupon interest rate differs from the prevailing rate applicable to similar notes, and the proceeds of the note differ from its face amount. As the Appendix to this Opinion demonstrates, such differences are related to differences between the present value upon issuance and the face amount of the note. The difference between the face amount and the proceeds upon issuance is shown as either discount or premium, which is amortized over the life of the note. (paragraph 6)

.05 APB Opinion 16, *Business Combinations*, gives general guidance for assigning amounts to loans acquired in a purchase business combination:

Receivables [should be recorded] at present values of amounts to be received determined at appropriate current interest rates, less allowances for uncollectibility and collection costs, if necessary. (paragraph 88[b])

.06 FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases*, describes the accounting for loans purchased at discounts:

The initial investment in a purchased loan or group of loans shall include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference shall be recognized as an adjustment of yield over the life of the loan. (paragraph 15)

Deferred net fees or costs shall not be amortized during periods in which interest income on a loan is not being recognized because of concerns about the realization of loan principal or interest. (paragraph 17)

Net fees or costs that are required to be recognized as yield adjustments over the life of the related loan(s) shall be recognized by the interest method except as set forth in paragraph 20. The objective of the interest method is to arrive at periodic interest income (including recognition of fees and costs) at a constant effective yield on the net investment in the receivable (that is, the principal amount of the receivable adjusted by unamortized fees or costs and purchase premium or discount). The difference between the periodic interest income so determined and the stated interest on the outstanding principal amount of the receivable is the amount of periodic amortization. (paragraph 18)

.07 The FASB's Emerging Issues Task Force's minutes for Issue 87-17 addressed accounting for spin-offs and other distributions of loans receivable to shareholders and relied in part on APB Opinion 29, *Accounting for Non-monetary Transactions*:

Other nonreciprocal transfers of nonmonetary assets to owners should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution. (paragraph 23)

The Emerging Issues Task Force minutes state:

An enterprise distributes loans receivable to its owners by forming a subsidiary and transferring those loans receivable to the subsidiary and then distributing the stock of that subsidiary to shareholders of the parent. If the book value of the loans receivable, which may be either the "recorded investment in the receivable" or the "carrying amount of the receivable," is in excess of their fair value, the accounting issue is whether the enterprise should report the distribution at book value as a spin-off or at fair value as a dividend-in-kind and how the recipient should record the transaction.

The Task Force reached a consensus that the assets should be reported at fair value by the enterprise and the recipient. Task Force members noted that the transaction is not a spin-off because the subsidiary is not an operating company. Rather, the transaction may be considered a dividend-in-kind. Under paragraph 23 of APB Opinion 29, *Accounting for Nonmonetary Transactions*, dividends-in-kind are nonreciprocal transfers of nonmonetary assets to owners that should be accounted for at fair value if the fair value of the nonmonetary asset distributed is objectively measurable and would clearly be realizable to the distributing entity in an outright sale at or near the time of distribution.

.08 SEC Staff Accounting Bulletin (SAB) No. 61, *Adjustments of Allowances for Business Combination Loan Losses—Purchase Method Accounting*, states that the allowance for credit losses related to loans acquired by a bank in a purchase business combination should be the same as the allowance provided for those loans by the acquired bank unless the acquiring bank's plans for the ultimate recovery of those loans differ from the plans that served as the basis for the acquired bank's estimation of losses on those loans.

.09 SAB No. 61 states that if the acquired bank's financial statements as of the acquisition date are not fairly stated because of an unreasonable allowance for credit losses, the acquired bank's preacquisition financial statements should be restated to reflect a reasonable allowance, with the resulting adjustment applied to the restated preacquisition income statement of the acquired bank; the allowance for credit losses may not be changed through a purchase accounting adjustment.

.10 *Audits of Banks* (2nd ed. [1983], pp. 51 and 52), an AICPA industry audit guide, includes guidance on the suspension of the accrual of interest income on loans and the subsequent treatment of amounts received on those loans:

Many banks suspend accrual of interest income on loans when the payment of interest has become delinquent or collection of the principal has become doubtful. Such action is prudent and appropriate. Regulatory reporting guidelines for nonaccrual loans have been established by federal supervisory agencies.

Although placing a loan in nonaccrual status, including loans accruing at a reduced rate, does not necessarily indicate that the principal of the loan is uncollectible in whole or in part, it generally warrants reevaluation of collectibility of principal and previously accrued interest. If amounts are received on a loan on which the accrual of interest has been suspended, a determination should be made about whether the payment received should be recorded as a reduction of the principal balance or as interest income.

If the ultimate collectibility of principal, wholly or partially, is in doubt, any payment received on a loan on which the accrual of interest has been suspended should be applied to reduce principal to the extent necessary to eliminate such doubt.

.11 Audits of Finance Companies (Including Independent and Captive Financing Activities of Other Companies), an AICPA industry audit and accounting guide, also includes guidance on the suspension of the accrual of interest income on loans:

A finance company's revenues from loans should be accrued over time in accordance with the terms of the contracts using the interest (actuarial) method. Even if collections are not timely, the amounts at which assets are recorded in the form of receivables generally should continue to increase. If collection is not probable, however, continuing to accrue income would not reflect economic substance. Accruals or amortization of discount and, in accordance with FASB Statement No. 91, paragraph 17, amortization of deferred net fees or costs should therefore be suspended if collectibility of interest or principal is not probable. The following are examples of events that could cause such uncertainty on consumer loans:

- a. The borrower is in default under the terms of the loan agreement, and interest or principal payments are past due (often a stipulated number of days past due as established in company policies).
- b. The ability of the borrower to repay is in doubt because of events such as a loss of employment or bankruptcy.
- c. The loan terms have been renegotiated.

Identifying commercial loans on which interest should be suspended is, at least mechanically, more difficult because, unlike consumer loans, commercial loans usually lack homogeneous characteristics. In addition to the factors described above, considerations may include whether—

- a. Significant unsecured balances are due from debtors suffering continued operating losses.
- b. The financial condition of the debtor is weak.
- c. The outlook for the debtor's industry is unfavorable.
- d. The ratio of collateral values to loans has decreased because of changes in market conditions.
- e. A portion of the unpaid principal or accrued interest has been written off.

When recognition of interest has been suspended, interest income that has accrued on such loans should not be reversed even though receipt of those amounts may not be forthcoming. The potential uncollectibility of such amounts should be taken into consideration in the computation of the allowance for losses.

Accrual of interest generally should not be resumed until future collectibility of the loan and accrued interest becomes probable. Determining future collectibility is a matter of judgment that depends on considerations such as—

- Whether the customer has resumed making regular payments for a certain number of installments.
- Whether the reason for the customer's delinquency has been eliminated (such as reemployment of a consumer borrower or an improved economic outlook for a commercial borrower) or was an isolated circumstance unlikely to recur.

- Whether there are any other substantive indications of the customer's regaining an ability to repay the loan. (2d ed., rev., pp. 14-15)

.12 Some entities have amortized the discounts, or portions of the discounts, on certain acquired loans, with corresponding increases in income, over the estimated or contractual lives of the loans. The effect of such amortization has been to produce higher reported rates of return on loans that, before acquisition, yielded lower reported rates of return or no reported returns, despite the fact that the acquisition had no effect on the quality of the loans. AcSEC has concluded that it should examine the accounting in such circumstances.

Accounting Guidance

Date of Acquisition

.13 At the time of acquisition, the sum of the acquisition amount of the loan and the discount to be amortized should not exceed the undiscounted future cash collections that are both reasonably estimable and probable.² The discount on an acquired loan should be amortized over the period in which the payments are probable of collection only if the amounts and timing of collections, whether characterized as interest or principal, are reasonably estimable and the ultimate collectibility of the acquisition amount of the loan and the discount is probable. If these criteria are not satisfied, the loan should be accounted for using the cost-recovery method (see paragraphs .16 and .17).

.14 If at the date of acquisition it is known that interest income on a particular loan is not being recognized by the seller because of concerns about the collectibility of the loan principal or interest, it should be presumed that the loan does not meet the criteria in paragraph .13. That presumption may be overcome if the acquirer's assessment of factors affecting collectibility, such as those discussed in paragraph .18, strongly indicate that collection of the acquisition amount and the discount is probable and the amounts and timing of collections are reasonably estimable. In accordance with FASB Statement No. 91, discounts should be amortized using the interest method.

Subsequent to the Date of Acquisition

.15 Collectibility should continue to be evaluated throughout the life of the acquired loan. If, upon evaluation—

- The estimate of the total probable collections is increased or decreased but is still greater than the sum of the acquisition amount less collections plus the discount amortized to date and it is probable that collection will occur, the amount of the discount to be amortized should be adjusted accordingly. The adjustment should be accounted for as a change in estimate in accordance with APB Opinion 20, *Accounting Changes*, and the amount of periodic amortization adjusted over the remaining life of the loan.

² FASB Statement No. 91 states that the difference between the acquisition amount of the loan and the principal amount should be recognized as an adjustment of yield over the life of the loan. Statement No. 91 provides accounting guidance for loans acquired at a discount because of net origination fees and costs and differences between prevailing interest rates on the date of origination and the date of acquisition. This practice bulletin addresses amortization of discounts on acquired loans that reflect impairment of the borrowers' credit.

- The estimate of amounts probable of collection is reduced and it is less than the acquisition amount less collections plus the discount amortized to date, amortization should cease, and either the loan should be written down or an allowance for uncollectibility relating to that loan should be recognized.
- It is not possible to estimate the amount and timing of collection, amortization should cease, and the cost-recovery method should be used as described in paragraph .17 below.
- It is determined that collection is less than probable, amortization should cease, either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized, and the cost-recovery method should be used as described in paragraph .17 below.
- It is determined that the loan is held primarily for the rewards of ownership of the underlying nonmonetary collateral, the collateral should be accounted for in accordance with the guidance on ADC arrangements in AcSEC Practice Bulletin 1 [section 12,010].

Cost-Recovery Method

.16 Application of the cost-recovery method requires that any amounts received be applied first against the recorded amount of the loan; when that amount has been reduced to zero, any additional amounts received are recognized as income.

.17 The cost-recovery method should be used until it is determined that the amount and timing of collections are reasonably estimable and collection is probable. If the remaining amount that is probable of collection is less than the sum of the acquisition amount less collections and the discount amortized to date, then either the loan should be written down or an allowance for uncollectibility related to that loan should be recognized. If the remaining amount that is probable of collection is greater than that sum, then the difference between that sum and the revised amount that is probable of collection should be amortized on a prospective basis over the remaining life of the loan.

Collectibility

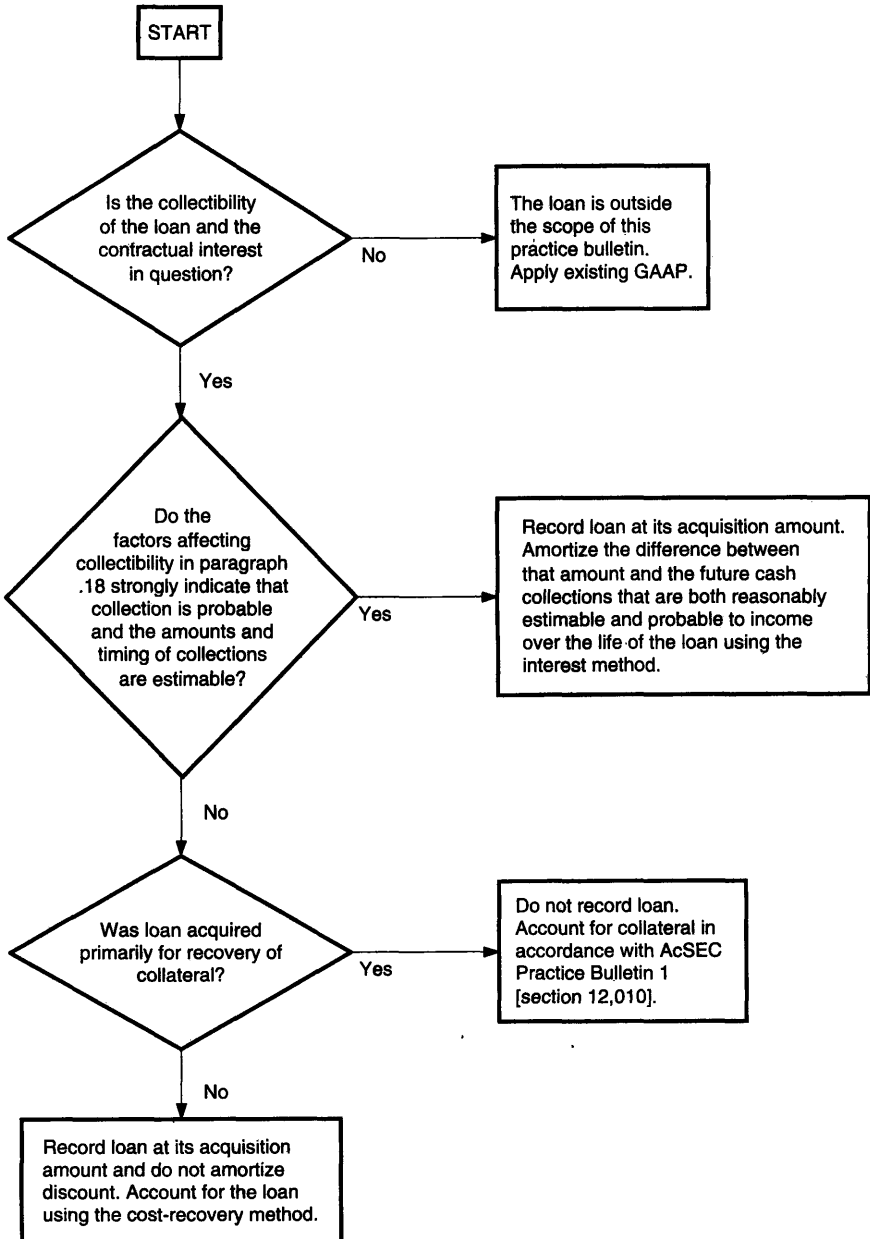
.18 Whether the acquisition amount of an acquired loan less collections and the discount amortized to date are collectible is a matter of judgment. Some of the factors that should be considered in assessing collectibility include—

- a. The financial condition of the borrower.
- b. A substantial equity of the borrower in the collateral underlying the loan that is *not* funded by the lender. This may reflect, to some extent, the borrower's commitment to pay the loan.
- c. Historical cash flows from the acquired loan.
- d. The prospect of near-term cash flows from the acquired loan.
- e. Irrevocable letters of credit, enforceable personal guarantees, or takeout commitments from creditworthy parties. (The guidance on ADC arrangements in AcSEC Practice Bulletin 1 [section 12,010], may be useful in evaluating these items.)

- f.* The nature of any asset underlying the loan and the probability that it will generate sufficient future cash flows to cover future principal and interest payments when due (for example, the forecasted earnings of a commercial property that are expected to cover future principal and interest payments on a loan).

Appendix A

Accounting at the Date of Acquisition



Appendix B

Illustrations of the Application of the Practice Bulletin

These illustrations are provided to assist in the interpretation of the principles set forth in this practice bulletin. They are not intended to provide guidance on whether the transactions should be accounted for as in-substance foreclosures.

Illustration 1

Z acquires a loan that is thirty days past due. Shortly after acquisition, the loan becomes current; collection of principal and interest is probable and the amounts and timing are reasonably estimable.

Task Force's Conclusion:

The discount should be amortized.

Illustration 2

Z acquires a loan that is thirty days past due. The loan is restructured with no loss recognized on the restructuring.

Additional Assumptions—A

The loan was restructured to pay no interest. Principal is to be paid in periodic installments, and it is probable that all of the principal will be collected.

Task Force's Conclusion:

The discount should be amortized, because the amount and timing of the cash flows that are probable of collection suggest that the presumption in paragraph .14 that the loan does not meet the criteria for amortization of discounts has been overcome.

Additional Assumptions—B

The loan was restructured to pay 4-percent interest, an amount less than the market rate and the original contractual rate. The original contractual principal payments continue to be made. The loan is not fully amortizing; that is, a substantial balloon payment will be required at maturity.

Task Force's Conclusion:

Due to the significance of the balloon payment, sole reliance on the payment as a basis for overcoming the presumption in paragraph .14 that the loan does not meet the criteria for amortization of discounts is not appropriate. Other evidence that supports the probability of collection would have to be assessed.

Additional Assumptions—C

Same assumptions as in B, except that the original contractual principal payments have been reduced and, consequently, a larger balloon payment will be required at maturity. (The new periodic payment is based on an amortization schedule longer than the term of the loan.)

Task Force's Conclusion:

The discount should not be amortized.

Additional Assumptions—D

The loan was restructured to pay no interest; principal is to be paid in a single amount at maturity.

Task Force's Conclusion:

The discount should not be amortized.

Illustration 3

Z acquires a loan that is thirty days past due at acquisition and begins to accrue interest income receivable and amortize the discount. The loan becomes ninety days past due, and Z stops accruing interest.

Task Force's Conclusion:

Amortization of the discount should stop.

Illustration 4

Z acquires a loan that is thirty days past due at acquisition. The amount and timing of the future payments are reasonably estimable, and the amount is probable of collection. Z begins to accrue interest income receivable and amortize the discount. The borrower makes all subsequent required payments but does not bring the loan current—that is, the borrower does not make the missed payment.

Task Force's Conclusion:

The discount should continue to be amortized.

Illustration 5

Z acquires a loan on which the borrower is making the contractual interest payments when due. The entire principal is due in a lump sum at maturity. Z believes repayment of some of the principal is probable, but repayment of the remainder is less than probable.

Task Force's Conclusion:

The discount, that is, the difference between the acquisition amount and the sum of the part of the principal and interest payments that are reasonably estimable and probable of collection, should be amortized to income over the life of the loan using the interest method. If the estimate of the amount that is probable of collection is revised, the periodic amortization should be adjusted accordingly.

Illustration 6

Y, an acquired bank, had a loan that originally paid 12-percent interest and that was secured by cash flows from a producing oil well. The well had proven reserves and the collateral coverage was 125 percent of the loan based on net cash flows ([oil produced X market price of oil]— cost to produce).

The price of oil subsequently decreased. Y agreed to accept reduced interest payments in a troubled debt restructuring, because estimates of cash flows at that time indicated that the loan principal plus 4-percent interest would be repaid. The borrower will continue to operate the well, and it is reasonably possible that cash flows of the borrower from additional sources would become available to the bank.

Z acquired Y in a purchase business combination and, in accordance with APB Opinion 16, recorded the loan "at present values of amounts to be received determined at appropriate current interest rates." Z believes that the amount and timing of the cash flows are reasonably estimable and the amount is probable of collection.

Task Force's Conclusion:

Z should amortize the discount because the cash flows are probable. However, amortization of the discount should stop if the price of oil drops further such that the probability of collection becomes uncertain.

Illustration 7

Acquiree bank has a \$1,000,000 construction loan at 10-percent interest that was due on September 30, 1988. A takeout commitment on the loan was not honored, and the borrower continues to seek refinancing. The current market rate considering the creditworthiness of the borrower is 12 percent for a mortgage loan. Acquirer bank is acquiring Acquiree bank on December 31, 1988, at which time the loan is ninety days past due and interest is not being accrued. Acquirer bank is willing to renegotiate the loan so that it pays out. The borrower will operate the property, and it is reasonably possible that cash flows of the borrower from additional sources would become available to Acquirer bank.

Additional Assumptions—A

The property is leased under long-term leases. It is probable that the borrower will pay \$10,000 a month from cash flow from the property. Over eighteen years and nine months that amount would repay all principal and contractual interest on the loan (approximately \$2,250,000).

Task Force's Conclusion:

Acquirer bank should discount \$2,250,000 at 12 percent and amortize the resulting discount to income, because the future cash collections are both reasonably estimable and probable.

Additional Assumptions—B

The property is 25 percent leased under long-term leases. It is probable that the borrower will pay \$5,000 a month from cash flow from the property. Over twenty-five years (the estimated useful life of the property) that amount (\$1,500,000) would not repay all principal and interest on the loan.

Task Force's Conclusion:

Acquirer bank should discount \$1,500,000 at 12 percent and amortize the resulting discount to income, because the future cash collections totaling that amount are both reasonably estimable and probable.

Additional Assumptions—C

The property is not leased, and the borrower is unable to determine when payments can be made.

Task Force's Conclusion:

Acquirer bank would record the loan at the fair value of the note and account for it using the cost-recovery method. (If the Acquirer bank expects to obtain repayment of the loan through foreclosure of the underlying collateral, the collateral should be accounted for in accordance with AcSEC Practice Bulletin 1 [section 12,010].)

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Section 12,080

Practice Bulletin 8 **Application of FASB Statement No. 97,** **Accounting and Reporting by Insurance** **Enterprises for Certain Long-Duration** **Contracts and for Realized Gains and** **Losses From the Sale of Investments, to** **Insurance Enterprises**

November, 1990

NOTICE TO READERS

Practice bulletins of the Accounting Standards Division are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

The Financial Accounting Standards Board and the Governmental Accounting Standards Board are the bodies authorized to establish enforceable standards under rule 203 of the AICPA Code of Professional Conduct. However, practice bulletins provide guidance on narrow issues that practitioners are encouraged to follow to enhance the quality and comparability of financial statements.

.01 This practice bulletin provides guidance, in the form of questions and answers, for insurance enterprises regarding the application of Financial Accounting Standards Board (FASB) Statement No. 97, *Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments*.

Acquisition Costs

.02 *Question 1:* Is the definition of capitalized acquisition costs for investment contracts and universal life-type contracts under FASB Statement No. 97 the same as the definition under FASB Statement No. 60, *Accounting and Reporting by Insurance Enterprises*?

.03 FASB Statement No. 60, paragraph 28, defines acquisition costs as "those costs that vary with and are primarily related to the acquisition of new and renewal insurance contracts."

.04 *Answer 1:* Yes. However, FASB Statement No. 97, paragraph 24, specifies that certain acquisition costs should not be capitalized, but instead should be considered as maintenance and other period costs that are expensed as incurred, as follows:

Acquisition costs that vary in a constant relationship to premiums or insurance in force, are recurring in nature, or tend to be incurred in a level amount from period to period, shall be charged to expense in the period incurred.

.05 Certain acquisition costs have been excluded because, under FASB Statement No. 97, capitalized acquisition costs for universal life-type contracts and investment contracts ordinarily are amortized in relation to estimated gross profits, whereas under FASB Statement No. 60, capitalized acquisition costs are amortized in proportion to premium revenue recognized. Costs such as recurring premium taxes and ultimate level commissions, which vary with premium revenue, are effectively charged to expense in the periods incurred.

.06 Question 2: What method should be used for amortizing deferred policy acquisition costs (DPAC) incurred on investment contracts?

.07 Answer 2: The amortization method described in FASB Statement No. 97 for universal life-type contracts should be used for investment contracts that include significant surrender charges or that yield significant revenues from sources other than the investment of contract holders' funds. This method matches the amortization of DPAC with the recognition of gross profits. Otherwise, DPAC on investment contracts should be amortized using an accounting method that recognizes acquisition and interest costs as expenses at a constant rate applied to net policy liabilities and that is consistent with the interest method under FASB Statement No. 91, *Accounting for Nonrefundable Fees and Costs Associated With Originating or Acquiring Loans and Initial Direct Costs of Leases* (interest method).

.08 Under both the FASB Statement No. 97 amortization method and the interest method, assumptions used should be updated to be consistent with the concepts underlying the method used:

- Under the FASB Statement No. 97 amortization method, assumptions should be updated in compliance with paragraph 25 of FASB Statement No. 97, which states that "estimates of expected gross profit used as a basis for amortization shall be evaluated regularly, and the total amortization recorded to date shall be adjusted by a charge or credit to the statement of earnings if actual experience or other evidence suggests that earlier estimates should be revised."
- Under the interest method, the incidence of surrenders (if they are probable and can be reasonably estimated) can be anticipated for purposes of determining the amortization period. The rate of DPAC amortization should be adjusted for changes in the incidence of surrenders to be consistent with the handling of principal prepayments under FASB Statement No. 91.
- DPAC related to investment contracts should be reported as an asset to be consistent with the reporting of DPAC on insurance products covered by FASB Statement No. 97. Under some reserving methods, the insurance reserve may be calculated net of DPAC. In that event, the amounts of DPAC and reserves have to be determined separately.

Limited-Payment Contracts

.09 Question 3: Should the deferred profit liability (excess of gross premiums over net premiums), if any, on limited-payment contracts be amortized

in relation to the discounted amount of insurance in force (or expected future benefit), and should interest accrue to the unamortized deferred profit liability balance?

.10 Answer 3: Yes. The deferred profit liability should be amortized in relation to the discounted amount of the insurance in force or expected future benefit payments, and interest should accrue to the unamortized balance. The use of interest in the amortization is consistent with the determination of the deferred profit using discounting.

.11 Question 4: Should costs related to the acquisition of new and renewal business that are not capitalized (because, for example, the costs do not vary with the acquisition of the business) be included in the calculation of net premium used in determining the profit to be deferred on limited-payment contracts?

.12 Answer 4: No. Those costs are period costs, which should be recognized when incurred. The inclusion of such costs in the calculation of net premium would result in their deferral.

.13 Costs that would be included in the determination of net premium under FASB Statement No. 97 and for purposes of determining the deferred profit for limited-payment contracts are policy-related costs that are not primarily related to the acquisition of business (such as policy administration, maintenance, and settlement costs) and acquisition costs that are capitalized under FASB Statement No. 97.

.14 Question 5: Does the method of amortizing DPAC on limited-payment contracts under FASB Statement No. 97 differ from the method required under FASB Statement No. 60?

.15 Answer 5: No. DPAC should continue to be amortized in proportion to premium revenue recognized, as required under FASB Statement No. 60, paragraph 29. Premium revenue used in the calculation should be the gross premium recorded, that is, the amount before adjustment for excess of gross over net premiums (the deferred profit liability).

.16 Question 6: Does paragraph 16 of FASB Statement No. 97, which addresses limited-payment contracts, apply to limited-payment participating and limited-payment nonguaranteed-premium contracts that are not, in substance, universal life-type contracts?

.17 Answer 6: Yes. These contracts are limited-payment contracts under paragraph 9 of FASB Statement No. 97 and are not excluded under paragraph 11 because they are not conventional forms of participating or nonguaranteed-premium contracts.

Internal Replacements

.18 Question 7: Does the accounting specified by FASB Statement No. 97, paragraph 26, for internal replacement transactions apply only to the replacement of traditional insurance contracts by universal life-type contracts?

.19 Answer 7: Yes. FASB Statement No. 97 addresses only replacements of traditional insurance contracts by universal life-type contracts. The accounting for other internal replacements should be based on the circumstances of the transaction. Paragraphs 70 to 72 of FASB Statement No. 97 discuss the Board's rationale for requiring recognition of loss on the termination of the replaced contract.

.20 Question 8: How should insurance enterprises report changes in accounting practices for internal replacements other than replacements by universal life-type contracts?

.21 Answer 8: If the accounting practice for internal replacements other than replacement by a universal life-type contract is changed, and if the effect is material, insurance enterprises should disclose the change in their reports to shareholders as a change in accounting principle, as described in paragraphs 18 to 26 of APB Opinion No. 20, *Accounting Changes*.

Scope of FASB Statement No. 97

.22 Question 9: According to paragraph 14 of FASB Statement No. 97, the statement does not apply to certain long-duration insurance contracts, such as those that provide benefits related only to illness, physical injury, or disability. Should FASB Statement No. 97 be applied to contracts that provide those kinds of benefits but that also have characteristics and benefits falling under FASB Statement No. 97, such as significant cash surrender benefits and limited-payment or universal-type provisions?

.23 Answer 9: Yes. If insurance contracts have characteristics significant to the contracts that are covered by FASB Statement No. 97—for example, limited-payment or universal life-type contracts—the accounting for the contracts should be guided by the concepts of FASB Statement No. 97. For example, universal disability contracts that have many of the same characteristics as universal life-type contracts, with the exception of providing disability benefits instead of life insurance benefits, should be accounted for in a manner consistent with universal life-type contracts.

Estimated Gross Profits—Universal Life-Type Contracts

.24 Question 10: FASB Statement No. 97, paragraph 23b, states that estimated gross profits (EGP) used to determine DPAC amortization for universal life-type contracts should include estimates of costs expected to be incurred for contract administration, including acquisition costs not included in capitalized acquisition costs. What kinds of costs should be included in contract administration costs, and should non-policy-related costs and costs that are not capitalized under FASB Statement No. 60, paragraph 28, because they do not vary with the acquisition of new and renewal insurance contracts be included?

.25 Answer 10: Contract administration costs included in the calculation of EGP should consist of the following:

- Policy-related costs that are not primarily related to the acquisition of business, such as policy administration, settlement, and maintenance costs
- Policy-related acquisition costs that are not capitalized under FASB Statement No. 97, paragraph 24, such as ultimate renewal commission and recurring premium taxes

.26 Non-policy-related expenses, such as certain overhead costs, and costs that are related to the acquisition of business that are not capitalized under FASB Statement No. 60, such as certain advertising costs, should not be included in EGP.

.27 Question 11: Should gains and losses from sales of investments be included in amounts expected to be earned from the investment of policyholder balances used to determine EGP?

.28 Answer 11: Yes. Expected gains and losses from sales of investments related to universal life contracts should be included in the determination of EGP, because earned investment income should be based on the expected total yield of the investments. If the timing and amount of realized gains and losses from the sales of investments change from those expected and materially affect the expected total yield and the estimated gross profits, DPAC amortization should be reevaluated.

Transition

.29 Question 12: Accounting changes resulting from the adoption of FASB Statement No. 97 are required to be applied retroactively through restatement of all previously issued financial statements that are being presented. FASB Statement No. 97 requires that if restatement of all years presented is not practicable, the cumulative effect of the accounting changes be reported in net income in the year the statement is adopted. If a company is adopting FASB Statement No. 97 through a cumulative-effect adjustment because restatement is not practicable, should the company nevertheless restate prior years' income statements for the change in reporting realized investment gains and losses under FASB Statement No. 97?

.30 Answer 12: Yes. A company should adopt FASB Statement No. 97's change in reporting realized investment gains and losses through restatement of prior years' income statements even if other provisions of the standard are adopted through a cumulative-effect adjustment. A company should adopt all provisions of FASB Statement No. 97 in the same period.

.31 Question 13: When adopting FASB Statement No. 97 retroactively through restatement of prior years' financial statements, should companies use the original accounting assumptions, such as assumptions regarding estimated gross profits, that they would have used in those prior periods, or may hindsight be used so that experience subsequent to those periods may be substituted for original assumptions?

.32 Answer 13: Assumptions used in restating prior years' financial statements should not include significant subsequent fluctuations in experience that could not reasonably have been foreseen—for example, a significant unexpected change in lapse experience resulting from specific circumstances occurring in a subsequent period, restructuring of policy charges, or a major change in investment strategy. The effects of such changes should be included in the restated results of the period in which the changes occurred, which may require the adjustment of total DPAC amortization recorded to date as specified in paragraph 25 of FASB Statement No. 97.

Recoverability and Loss Recognition— Investment Contracts

.33 Question 14: Should DPAC related to investment contracts defined under FASB Statement No. 97 be written off if it is determined that the amount at which the asset is stated is probably not recoverable?

.34 Answer 14: Yes. As stated in paragraph 87 in FASB Statement of Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, “[a]n expense or loss is recognized if it becomes evident that previously recognized future economic benefits of an asset have been reduced or eliminated, or that a liability has been incurred or increased, without associated economic benefits.” The DPAC asset should be reduced to the level that can be recovered. Further guidance is provided in paragraphs .35 and .36 of this practice bulletin.

.35 Question 15: Should the provisions of FASB Statement No. 60 concerning loss recognition (premium deficiency), by which an additional liability is established for anticipated losses on contracts, apply to investment contracts defined in FASB Statement No. 97?

.36 Answer 15: No. Such loss recognition, as described in paragraph .34 above, is not permitted for investment contracts under FASB Statement No. 97.

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Section 12,110**Practice Bulletin 11
Accounting for Preconfirmation
Contingencies in Fresh-Start Reporting**

March, 1994

NOTICE TO READERS

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Introduction

.01 This practice bulletin interprets certain provisions of AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* [section 10,460]. SOP 90-7 [section 10,460] provides guidance for financial reporting by entities that file petitions with the Bankruptcy Court and expect to reorganize as going concerns under Chapter 11 of title 11 of the United States Code. The SOP was issued on November 19, 1990, and is effective for financial statements of enterprises that filed petitions under the Bankruptcy Code after December 31, 1990.

.02 SOP 90-7 [section 10,460] states that an entity should adopt fresh-start reporting upon emergence from Chapter 11 reorganization if the reorganization value of assets immediately before the date of confirmation is less than the total of all postpetition liabilities and allowed claims, and if holders of existing voting shares immediately before confirmation receive less than 50 percent of the voting shares of the emerging entity. Reorganization value generally approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after restructuring. The reorganization value of an entity is the amount of resources available and to become available for the satisfaction of postpetition liabilities and allowed claims and interest, as negotiated or litigated between the debtor-in-possession or trustee, the creditors, and the holders of equity interests.

.03 SOP 90-7 [section 10,460] identifies the principles to be applied in adopting fresh-start reporting, which include the following:

- Reorganization value of the entity should be allocated to the entity's assets in conformity with the procedures specified by Accounting Principles Board (APB) Opinion No. 16, *Business Combinations*, for transactions recorded on the basis of the purchase method. Any reorganization value in excess of amounts allocable to identifiable assets should be amortized in conformity with APB Opinion 17, *Intangible Assets*.
- Each liability existing at the plan confirmation date, other than deferred taxes, should be stated at the present values of amounts to be paid.

.04 SOP 90-7 [section 10,460] does not provide specific guidance on accounting for contingencies existing at the date fresh-start reporting is adopted.¹ Some believe that the effects of adjusting or resolving all such contingencies should be included in postconfirmation earnings. Others believe that accounting similar to that in FASB Statement of Financial Accounting Standards No. 38, *Accounting for Preacquisition Contingencies of Purchased Enterprises*, should be applied. Such accounting could result in adjustments to reorganization value in excess of amounts allocable to identifiable assets. The Accounting Standards Executive Committee (AcSEC) has been asked to clarify the issue.

Interpretation

.05 Certain uncertainties that were not resolved during the Chapter 11 proceedings may continue to exist at the confirmation date. For purposes of applying SOP 90-7 [section 10,460], such uncertainties are referred to as *preconfirmation contingencies*, defined as contingencies² of an entity that emerges from Chapter 11 reorganization and applies fresh-start reporting, and that exist at the date of confirmation of the plan. A preconfirmation contingency can be a contingent asset, a contingent liability, or a contingent impairment of an asset.

.06 Preconfirmation contingencies include uncertainties concerning

- Amounts ultimately to be realized upon the disposition of assets designated for sale by the confirmed plan; proceeds upon disposition may vary from values estimated at confirmation.
- Nondischargeable claims (for example, environmental issues).
- Claims that are disputed, unliquidated, or contingent and that are unresolved at confirmation; these claims may be estimated for purposes of voting on the plan. The confirmed plan may provide for issuance of shares (or release of shares from escrow) in resolution of certain claims.

.07 Preconfirmation contingencies do not include—

¹ See paragraphs .35 and .55 of SOP 90-7 [section 10,460.35 and .55].

² FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, defines a contingency as an existing condition, situation, or set of circumstances involving uncertainty concerning possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

- Allocation of reorganization value to the entity's assets. The initial allocation of the value of the reconstituted entity to individual assets in conformity with the procedures specified by APB Opinion 16 may require the use of estimates. Those estimates may change when information the entity has arranged to obtain has been received—for example, once appraisals of certain assets of the reconstituted business have been received.
- Deductible temporary differences or net operating loss and tax-credit carryforwards that exist at confirmation. FASB Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*, and paragraph .38 of SOP 90-7 [section 10,460.38], specify the accounting for those items.

.08 After the adoption of fresh-start reporting, adjustments that result from a preconfirmation contingency shall be included in the determination of net income in the period in which the adjustment is determined. Such adjustments can result from resolution of a contingency or changes in estimates of amounts initially recorded at emergence from Chapter 11 (see paragraph .05 herein).

.09 Adjustment of preconfirmation contingencies should be included in income or loss from continuing operations of the emerged entity and should be separately disclosed.

.10 This practice bulletin is effective for adjustments of preconfirmation contingencies made after March 31, 1994. Earlier application is encouraged.

Basis for Conclusions

.11 Paragraph .58 of SOP 90-7 [section 10,460.58] states, in part, “. . . in the reorganization process, extensive information available to the parties in interest, the adversarial negotiation process, the involvement of the Bankruptcy Court, the use of specialists by one or more of the parties in interest, and the fact that all elements of the determination are focused solely on the economic viability of the emerging entity result in an objective and reliable determination of reorganization value.” Thus, all contingencies that are significant to the reorganization proceedings are identified and generally estimated by the confirmation date.

.12 FASB Statement No. 38 describes an allocation period as the time required by a purchaser of a business to identify and quantify the assets acquired and the liabilities assumed. The allocation period ends when the acquiring entity is no longer waiting for information that it has arranged to obtain and that is known to be available or obtainable. Any adjustment after the end of the allocation period that results from a preacquisition contingency is included in earnings. AcSEC believes that in reorganization proceedings the analogous allocation period for contingencies is the reorganization period, which ends at the confirmation date. Therefore, adjustments to the amounts initially recorded for preconfirmation contingencies at the adoption of fresh-start accounting should be reflected in earnings.

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Section 12,130

Practice Bulletin 13 Direct-Response Advertising and Probable Future Benefits

December, 1994

NOTICE TO READERS

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, identifies AICPA Practice Bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this Practice Bulletin should be used, or the member should be prepared to justify the departure.

Introduction

.01 In December 1993, the AICPA's Accounting Standards Executive Committee (AcSEC) issued Statement of Position (SOP) 93-7, *Reporting on Advertising Costs* [section 10,590]. SOP 93-7 [section 10,590] provides guidance on financial reporting on advertising costs and requires that an entity report the costs of all advertising as expenses either in the periods in which those costs are incurred, or the first time the advertising takes place, except for certain direct-response advertising. The costs of direct-response advertising that result in probable future benefits should be capitalized and amortized over the estimated period of the future benefits.

Direct-Response Advertising

.02 Paragraph 33 of SOP 93-7 [section 10,590.33] states that the costs of direct-response advertising should be capitalized if both of the following conditions are met:

- a. The primary purpose of the advertising is to elicit sales to customers who could be shown to have responded specifically to the advertising. (Paragraph 34 of SOP 93-7 [section 10,590.34] discusses the conditions that must exist in order to conclude that the advertising's purpose is to elicit sales to customers who could be shown to have responded specifically to the advertising.)

.09 Entities that adopt SOP 93-7 [section 10,590] on or prior to December 31, 1994, and that report the costs of direct-response advertising as assets based on the inclusion of secondary revenues in determining probable future revenues, may report advertising costs incurred on or prior to December 31, 1994, using one of the following alternatives:

- a. Continue to include secondary revenues in determining probable future revenues for purposes of amortizing and assessing the realizability of direct-response advertising reported as assets at December 31, 1994.
- b. For entities that have issued annual financial statements reflecting the adoption of SOP 93-7 [section 10,590], use only primary revenues for purposes of reporting the costs of direct-response advertising reported as assets and report the change in accounting as the cumulative effect of a change in accounting principle as prescribed by paragraph 20 of Accounting Principles Board Opinion No. 20, *Accounting Changes*.
- c. For entities that have not issued annual financial statements, use only primary revenues for purposes of reporting the costs of direct-response advertising as assets.

Discussion of Conclusion

Probable Future Revenues

.10 SOP 93-7 [section 10,590] establishes narrow conditions for reporting the costs of advertising as an asset beyond the first time the advertising takes place. Those conditions are based, in part, on future benefits resulting from the advertising. Some entities have interpreted SOP 93-7 [section 10,590] to allow the inclusion of secondary sources of revenue when determining probable future benefits. That practice extends, beyond AcSEC's intent, the link between the customers responding to the direct-response advertising and the probable future revenues resulting from the advertising. This practice bulletin clarifies that AcSEC intended that only primary revenues should be included in the determination of probable future revenues.

Transition

.11 SOP 93-7 [section 10,590] was issued in December 1993 and is effective for financial statements for years beginning after June 15, 1994, with earlier application encouraged in fiscal years for which financial statements previously have not been issued. SOP 93-7 [section 10,590] did not explicitly address the issue of whether secondary revenues should be included in probable future benefits. Therefore, some entities that early adopted SOP 93-7 [section 10,590] included secondary revenues in determining probable future revenues, and as a result reported direct-response advertising costs as assets that would not be reported as assets under this practice bulletin.

.12 AcSEC acknowledges that transition, to a significant extent, is a practical matter. A major objective of transition is to mitigate disruption to the extent possible without unduly compromising the objectives of the accounting guidance in this practice bulletin and consistency among reporting entities.

AcSEC believes that those entities that adopted SOP 93-7 [section 10,590] prior to its effective date did so in good faith and should not be required to restate annual financial statements previously issued. AcSEC further believes that few entities both adopted SOP 93-7 [section 10,590] prior to its effective date and included secondary revenues when determining probable future revenues. Therefore, consistency among reporting entities has not been compromised significantly.

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Section 12,140

Practice Bulletin 14 **Accounting and Reporting by Limited Liability Companies and Limited Liability Partnerships**

April, 1995

NOTICE TO READERS

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, identifies AICPA Practice Bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this Practice Bulletin should be used, or the member should be prepared to justify the departure.

Introduction

.01 The Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA) prepared the following guidance regarding the application of existing authoritative literature to limited liability companies and limited liability partnerships.

.02 U.S. limited liability companies and limited liability partnerships (hereinafter referred to as *limited liability companies or LLCs*) are formed in accordance with the laws of the state in which such entities are organized. Because those laws are not uniform, the characteristics of LLCs vary from state to state. However, LLCs generally have the following characteristics:¹

- An LLC is an unincorporated association of two or more “persons.”
- Its members have limited personal liability for the obligations or debts of the entity.

¹ The characteristics listed in this paragraph are not intended to be representative of characteristics in the statutes of each state. Preparers of an LLC's financial statements should be cognizant of the LLC legislation enacted in the jurisdiction in which the LLC is organized.

- It is classified as a partnership for federal income tax purposes.

.03 Under the rules in existence as of the date of this practice bulletin, to be classified as a partnership for federal income tax purposes, a limited liability company must lack at least two of the following corporate characteristics:²

- Limited liability
- Free transferability of interests
- Centralized management
- Continuity of life

Scope

.04 This practice bulletin provides reporting guidance for limited liability companies organized in the United States that prepare financial statements in accordance with generally accepted accounting principles. The practice bulletin also provides guidance on certain accounting issues for LLCs organized in the United States. For accounting issues not addressed in this practice bulletin, an LLC should comply with the existing requirements of generally accepted accounting principles.

Conclusions

Accounting Issues

Accounting for Assets and Liabilities Previously Owned by Predecessor Entities

.05 An LLC formed by combining entities under common control or by conversion from another type of entity initially should state its assets and liabilities at amounts at which they were stated in the financial statements of the predecessor entity or entities in a manner similar to a pooling of interests.

Accounting for Income Taxes

.06 As discussed in paragraph .02 of this practice bulletin, LLCs generally are classified as partnerships for federal income tax purposes. An LLC that is subject to federal (U.S.), foreign, state, or local (including franchise) taxes based on income should account for such taxes in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Paragraph 17 of FASB Statement No. 109 requires a jurisdiction-by-jurisdiction computation.

.07 In accordance with paragraph 28 of FASB Statement No. 109, an entity whose tax status in a jurisdiction changes from taxable to nontaxable should eliminate any deferred tax assets or liabilities related to that jurisdiction as of the date the entity ceases to be a taxable entity. Paragraph 45 of

² Many states have adopted similar requirements for limited liability companies to be classified as partnerships for state income or franchise tax purposes. However, certain states have enacted LLC legislation that includes income tax requirements. Additionally, if an LLC operates in a jurisdiction where either LLC legislation has not been enacted or LLCs are subject to income taxation, it may be subject to income tax requirements on income derived from operations in those jurisdictions.

FASB Statement No. 109 requires disclosure of significant components of income tax expense attributable to continuing operations including “adjustments of a deferred tax liability or asset for . . . a change in the tax status of the enterprise.”

Financial Statement Display Issues

.08 A complete set of LLC financial statements should include a statement of financial position as of the end of the reporting period, a statement of operations for the period, a statement of cash flows for the period, and accompanying notes to financial statements. Additionally, the LLC should present information related to changes in members' equity for the period. This information may be presented as a separate statement, combined with the statement of operations, or in the notes to the financial statements.

.09 The headings of a limited liability company's financial statements should identify clearly the financial statements as those of a limited liability company.

Presentation of the Equity Section of the Statement of Financial Position

.10 The financial statements of a limited liability company should be similar in presentation to those of a partnership. The LLC owners are referred to as “members”; therefore, the equity section in the statement of financial position should be titled “members' equity.” If more than one class of members exists, each having varying rights, preferences, and privileges, the LLC is encouraged to report the equity of each class separately within the equity section. If the LLC does not report the amount of each class separately within the equity section, it should disclose those amounts in the notes to the financial statements (see paragraph .15).

.11 Even though a member's liability may be limited, if the total balance of the members' equity account or accounts described in the preceding paragraph is less than zero, a deficit should be reported in the statement of financial position.

.12 If the LLC maintains separate accounts for components of members' equity (for example, undistributed earnings, earnings available for withdrawal, or unallocated capital), disclosure of those components, either on the face of the statement of financial position or in the notes to the financial statements, is permitted.

.13 If the LLC records amounts due from members for capital contributions, such amounts should be presented as deductions from members' equity. Presenting such amounts as assets is inappropriate except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time, as described in Emerging Issues Task Force (EITF) Issue No. 85-1, *Classifying Notes Received for Capital Stock*.

Comparative Financial Statements

.14 Presentation of comparative financial statements is encouraged, but not required, by Chapter 2A, “Comparative Financial Statements,” of Accounting Research Bulletin (ARB) No. 43, *Restatement and Revision of Accounting Research Bulletins*. If comparative financial statements are presented, amounts shown for comparative purposes must be in fact comparable with those shown for the most recent period, or any exceptions to comparability must be disclosed in the notes to the financial statements. Situations may exist in which financial statements of the same reporting entity for periods prior to

the period of conversion are not comparable with those for the most recent period presented, for example, if transactions such as spin-offs or other distributions of assets occurred prior to or as part of the LLC's formation. In such situations, sufficient disclosure should be made so the comparative financial statements are not misleading. If the formation of the LLC results in a new reporting entity, the guidance in Accounting Principles Board (APB) Opinion No. 20, *Accounting Changes*, paragraphs 34 and 35, should be followed and financial statements for all prior periods presented should be restated.

Financial Statement Disclosure Issues

.15 The following disclosures should be made in the financial statements of a limited liability company:

- A description of any limitation of its members' liability
- The different classes of members' interests and the respective rights, preferences, and privileges of each class. Additionally, as discussed in paragraph .10, if the LLC does not report separately the amount of each class in the equity section of the statement of financial position, those amounts should be disclosed.

If the LLC has a finite life, the date the LLC will cease to exist should be disclosed.

.16 For limited liability companies formed by combining entities under common control or by conversion from another type of entity, the notes to the financial statements for the year of formation should disclose that the assets and liabilities previously were held by a predecessor entity or entities. LLCs formed by combining entities under common control are encouraged to make the relevant disclosures in paragraph 64 of APB Opinion 16, *Business Combinations*.

.17 FASB Statement No. 109 requires specific disclosures relating to accounting for income taxes. LLCs subject to income tax in any jurisdiction should make the relevant FASB Statement No. 109 disclosures.

.18 As discussed in paragraph .14, if comparative financial statements are presented, additional disclosures may be required.

Effective Date

.19 This practice bulletin is effective for financial statements issued after May 31, 1995.

Discussion of Conclusions

Accounting Issues

.20 If an LLC is formed by combining entities under common control or by conversion from another form of entity, the assets and liabilities transferred to the LLC from the predecessor entity or entities should be recorded at historical cost in a manner similar to a pooling of interests. This position is supported by the following authoritative pronouncements:

- AICPA Accounting Interpretation No. 39 to APB Opinion 16, "Transfers and Exchanges Between Companies Under Common Control," which discusses transfers of net assets and exchanges of shares be-

tween companies under common control. The Interpretation states that assets and liabilities transferred between entities under common control would be accounted for in a manner similar to a pooling of interests.

- EITF Issue No. 88-16, *Basis in Leveraged Buyout Transactions*, which provides guidance as to when a new basis of accounting is appropriate in a leveraged buyout. Section 1 of Issue No. 88-16 states that a partial or complete change in accounting basis is appropriate only when there has been a change in control of voting interest (that is, a new controlling shareholder or group of shareholders must be established).

Financial Statement Display Issues

.21 AcSEC believes that the financial statements required by paragraph .08 of this practice bulletin are necessary to provide the information needed to meet the financial reporting objectives of a limited liability company and to report that information in a manner that is both comprehensive and understandable. The required financial statements are consistent with paragraph 13 of FASB Statement of Financial Accounting Concepts No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

.22 AcSEC believes that, because the members' liability is limited, the headings of the financial statements should state prominently that the entity is a limited liability company, even in jurisdictions where LLCs are not required by law to include the LLC designation in its name.

.23 In corporate financial statements, the amounts initially invested (capital stock) are kept separate from subsequent income and distribution amounts. In a partnership, such separation is not maintained. AcSEC believes that such a separation is not needed for LLCs. Consequently, AcSEC believes that the presentation of the equity section of the statement of financial position should be similar to that of a partnership rather than to that of a corporation.

.24 ARB 43, chapter 2A, recommends presentation of comparative financial statements. It states, however, that "it is necessary that prior-year figures shown for comparative purposes be in fact comparable with those shown for the most recent period, or that any exceptions to comparability be clearly brought out." Formation of a limited liability company by conversion from another type of entity (such as a partnership or corporation) generally does not result in a different reporting entity; formation of an LLC by combining entities under common control should result in a change in reporting entity, unless the entities were presented previously in combined financial statements.

.25 EITF Issue No. 85-1 addresses a situation in which an enterprise receives a note, rather than cash, as a contribution to equity. The task force reached a consensus that reporting the note as an asset generally is not appropriate, except in very limited circumstances when there is substantial evidence of ability and intent to pay within a reasonably short period of time.

Financial Statement Disclosure Issues

.26 As discussed in paragraph .03 of this practice bulletin, a limited liability company must lack at least two corporate characteristics to avoid being classified as an association for federal income tax purposes, and most limited liability companies do lack at least two of those characteristics. If one of the characteristics that the LLC lacks is "continuity of life," AcSEC believes

that fact should be disclosed since it may be of significant interest to financial statement users that enter into transactions with the LLC. For example, a limited life would be significant information to a lender lending funds to an entity on a long-term basis.

.27 If an LLC is formed by a combination of entities under common control, the LLC is encouraged to make the relevant disclosures required by paragraph 64 of APB Opinion 16, because those transactions are considered to be similar to poolings of interests.

.28 AcSEC believes that the relationship between preferences of the classes may be of major significance to users of financial statements of those companies. Therefore, disclosure of the different classes and their respective rights, preferences, and privileges is encouraged.

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Section 12,150

Practice Bulletin 15 Accounting by the Issuer of Surplus Notes

January, 1997

NOTICE TO READERS

Practice Bulletins are issued to disseminate the views of the Accounting Standards Executive Committee on narrow financial accounting and reporting issues. The issues dealt with are those that have not been and are not being considered by the Financial Accounting Standards Board or the Governmental Accounting Standards Board. Practice Bulletins present the views on such issues of at least two-thirds of the members of the Accounting Standards Executive Committee, the senior technical body of the AICPA authorized to speak for the AICPA on financial accounting and reporting.

Statement on Auditing Standards No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, identifies AICPA Practice Bulletins as a source of established accounting principles generally accepted in the United States that an AICPA member should consider if the accounting treatment of a transaction or event is not specified by a pronouncement covered by Rule 203 of the AICPA Code of Professional Conduct. If relevant to the circumstances of the transaction or event, the accounting treatment specified by this Practice Bulletin should be used, or the member should be prepared to justify the departure.

Introduction and Background

.01 Surplus notes¹ are financial instruments issued by insurance enterprises that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations.

.02 The following are some general characteristics of surplus notes:

- Approval of the issuance by the domiciliary state insurance commissioner (commissioner)
- Stated maturity date in most but not all cases
- Scheduled interest payments
- Approval of the payment of principal and interest by the commissioner
- Nonvoting
- Subordinate to all claims except those of shareholders for stock companies

¹ The term surplus notes is the most common term applied to these financial instruments. Some jurisdictions refer to these financial instruments as certificates of contribution, surplus debentures, or capital notes.

- Subordinate to all claims except policyholder residuals for mutual companies (after policyholder liabilities are settled)
- No or limited acceleration rights other than for rehabilitation, liquidation, or reorganization of the insurer by a governmental agency
- Proceeds from issuance in the form of cash, cash equivalent, or some other asset with a readily determinable fair value satisfactory to the commissioner

.03 Mutual insurance enterprises are owned by their policyholders and cannot raise capital by issuing shares of common or preferred stock; thus, many mutual insurance enterprises have issued surplus notes. Early issuances of surplus notes were generally by financially troubled mutual insurance enterprises in need of raising capital with limited alternatives to do so. More recently, mutual life insurance enterprises which do not have access to traditional equity capital markets, have viewed these instruments as a viable method of raising capital and improving risk-based capital ratios.

.04 Mutual life insurance enterprises currently account for surplus notes under statutory accounting practices almost universally as equity capital or surplus. Surplus treatment is allowed for statutory accounting purposes because of the regulatory control over an insurance enterprise's ability to repay interest and principal that is maintained through required approval of payment by the commissioner.

.05 The accounting for and presentation of surplus notes under generally accepted accounting principles (GAAP) is a significant issue to mutual life insurance enterprises when implementing FASB Interpretation No. 40, *Applicability of Generally Accepted Accounting Principles to Mutual Life Insurance and Other Enterprises*, and FASB Statement of Financial Accounting Standards No. 120, *Accounting and Reporting by Mutual Life Insurance Enterprises and by Insurance Enterprises for Certain Long-Duration Participating Contracts*. According to FASB Interpretation No. 40 as amended by FASB Statement No. 120, mutual life insurance enterprises that issue financial statements for fiscal years beginning after December 15, 1995, that are described as prepared "in conformity with generally accepted accounting principles" are required to apply all applicable authoritative accounting pronouncements in preparing those statements. Current authoritative accounting pronouncements are silent as to the accounting for surplus notes. Due to the prevalence and increasing use of these instruments by all kinds of insurance enterprises in the marketplace, GAAP guidance is necessary.

Scope

.06 This Practice Bulletin applies to life and health insurance enterprises (including mutual life insurance enterprises), property and casualty insurance enterprises, reinsurance enterprises, title insurance enterprises, mortgage guaranty insurance enterprises, financial guaranty insurance enterprises, assessment enterprises, fraternal benefit societies, reciprocal or interinsurance exchanges, pools other than public-entity risk pools, syndicates, and captive insurance companies that issue surplus notes. It provides guidance on accounting, financial statement presentation, and disclosure by the issuers of surplus notes in their GAAP financial statements. This Practice Bulletin does not apply to investors in surplus notes.

Conclusions

Balance-Sheet Classification of Outstanding Surplus Notes

.07 Surplus notes should be accounted for as debt instruments and presented as liabilities in the financial statements of the issuer. Equity treatment for surplus notes is inappropriate. This Practice Bulletin does not establish new guidance for accounting for debt instruments by the issuer.

.08 Consistent with paragraph 16 of FASB Statement No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities*, a debtor shall derecognize a surplus note if and only if it has been extinguished. According to paragraph 16 of FASB Statement No. 125,² a liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes delivery of cash, other financial assets, goods, or services or reacquisition by the debtor of its outstanding debt securities whether the securities are canceled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability either judicially or by the creditor. [*Footnote omitted*]

Accrual of Interest

.09 Interest should be accrued over the life of the surplus note, irrespective of the approval of interest and principal payments by the insurance commissioner, and recognized as an expense in the same manner as other debt.

Disclosure

.10 Issuers of surplus notes should comply with existing disclosure requirements for debt instruments. In addition, disclosure is required regarding the commissioner's role and ability to approve or disapprove any interest and principal payments.

Effective Date and Transition

.11 This Practice Bulletin is effective for financial statements for fiscal years beginning after December 15, 1995. The effect of initially applying this Practice Bulletin shall be reported retroactively through restatement of all previously issued financial statements presented for comparative purposes. The cumulative effect of adopting this Practice Bulletin, including the accrual of interest, if any, shall be included in the earliest year restated.

<p style="text-align: center;">The provisions of this Practice Bulletin need not be applied to immaterial items.</p>

Basis for Conclusions

.12 This section discusses considerations that were deemed significant by members of AcSEC in reaching the conclusions in this Practice Bulletin. It includes reasons for accepting certain views and rejecting others.

² FASB Statement No. 125 supersedes FASB Statement No. 76, *Extinguishment of Debt*.

Balance-Sheet Classification of Outstanding Surplus Notes

.13 AcSEC considered the characteristics of surplus notes and deemed them liabilities in accordance with FASB Concepts Statement No. 6, *Elements of Financial Statements*.

.14 FASB Concepts Statement No. 6 defines both liabilities and equity and describes their essential characteristics. Paragraph 35 of the Concepts Statement defines liabilities as “probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.”

.15 Paragraph 36 of FASB Concepts Statement No. 6 describes the following three essential characteristics of a liability.

(a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

.16 Surplus notes represent a present duty to the holders of the notes that entails settlement by probable future transfers of cash. The future transfers of cash are normally on specified dates, subject to the approval of the commissioner. If the commissioner does not grant approval for payment on a specified date, the future transfer of cash takes place on occurrence of a specified event, which is the ultimate approval of the commissioner. Therefore, surplus notes meet the first characteristic of a liability. In addition, AcSEC observed that declaration of bankruptcy by an enterprise and the role of the court in determining when and in what amounts an obligation will be settled do not affect whether the debt instrument continues to qualify as a liability.

.17 Should the commissioner not grant approval for an interest or principal payment, the issuer cannot make the payment and the holders of the notes have no recourse. The commissioner will grant approval only if it is consistent with his or her responsibility and objective to maintain the solvency and financial stability of the insurer. Although the commissioner has discretion, AcSEC concluded that the commissioner is not part of the organization. The discretion described in FASB Concepts Statement No. 6 is not delegable outside the enterprise. The entity has little or no discretion to avoid the future sacrifice and thus surplus notes do meet the second characteristic of a liability.

.18 AcSEC concluded that the previous transfer of cash to enterprises from the noteholder in return for the issuance of the surplus note is the event needed to obligate the entity and therefore surplus notes meet the third characteristic of a liability.

.19 Equity of a business enterprise is defined in paragraph 60 of FASB Concepts Statement No. 6 simply as a residual interest—the difference between an enterprise’s assets and its liabilities. Equity of a business enterprise stems from ownership rights or the equivalent, and it involves a relationship between an enterprise and its owners as owners rather than as employees, suppliers, lenders, or in other nonowner roles.

.20 FASB Concepts Statement No. 6 explains that the essential characteristics of equity center on the conditions for transferring enterprise assets to the holders of equity interests. Distributions to owners are at the discretion and

volition of the owners or their representatives after satisfying restrictions imposed by law, regulation, or agreements with other entities. In most circumstances, an enterprise is not obligated to transfer assets to owners except in the event of the enterprise's liquidation unless it formally acts to do so, such as by declaring a dividend. An enterprise's liabilities and equity are mutually exclusive claims to or interests in its assets by other entities, and liabilities take precedence over ownership interests.

.21 Surplus note payments require the approval of the commissioner. The commissioner's responsibilities and objectives include maintaining the solvency and financial stability of the insurer. AcSEC concluded that although the commissioner has the ability to restrict payments of interest and principal, the issuer continues to have the obligation even though the timing may be uncertain. Actions by the commissioner do not formally discharge the issuer's obligation to pay the principal or interest. Therefore, the characteristics of surplus notes are not consistent with the characteristics of equity as described in FASB Concepts Statement No. 6.

Surplus Notes—Statutory Basis

.22 Statutory accounting practices for surplus notes generally are consistent among all the states. Once approved by the commissioner, these instruments are classified as surplus on the balance sheet. Interest is reported as an expense and a liability only after payment has been approved by the commissioner. Interest that has not yet been approved for payment is not accrued as an expense and liability but rather disclosed in the notes to the financial statements. AcSEC observed that the objectives of regulatory accounting requirements are not always consistent with GAAP, and differences in accounting for other transactions currently exist.

Other Instruments With Similar Characteristics

.23 AcSEC considered other instruments with similar characteristics to surplus notes. Subordinated liabilities of broker/dealers, mandatorily redeemable preferred stock, and hybrid preferred securities such as monthly/quarterly income preferred stock (MIPS/QUIPS) have characteristics of both liabilities and equity and are generally presented on the balance sheet as a separate component between liabilities and equity.

Subordinated Liabilities of Broker/Dealers

.24 Insurance enterprise surplus notes have many of the same characteristics as subordinated liabilities of brokers and dealers in securities. Both kinds of instruments qualify as capital for regulatory purposes, are subordinated to all other claims except those of owners, and require regulatory approval or meeting of prescribed regulatory conditions before repayment. The revised AICPA Audit and Accounting Guide *Audits of Brokers and Dealers in Securities* does not permit reporting combined subordinated liabilities with stockholders' equity in the statement of financial condition, which was acceptable under the superseded guide. The superseded presentation was believed to be misleading because it implied that subordinated liabilities are a component of stockholders' equity, unencumbered by the right of the creditor to be repaid. Liabilities frequently have repayment limitations of one sort or another, but nevertheless remain liabilities. AcSEC concluded that accounting for surplus notes as a liability is consistent with the accounting for subordinated liabilities of brokers and dealers.

Mandatorily Redeemable Preferred Stocks and Hybrid Preferred Securities

.25 Surplus notes and mandatorily redeemable preferred stocks are similar in that both are subordinated to other claims and because of the terms of the redemption as prescribed by the instrument; once issued, redemption is outside the control of the issuer. AcSEC concluded that although practice is to show mandatorily redeemable preferred stock in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC was not persuaded that surplus notes, an instrument that meets all the characteristics of a liability, should be required or permitted to be displayed other than as a liability.

.26 Hybrid preferred securities such as monthly and quarterly income preferred securities (MIPS/QUIPS) are securities issued by a special-purpose entity that lends the proceeds to its controlling company. AcSEC concluded that although the practice is to show hybrid preferred securities in a separate category between liabilities and equity, to treat surplus notes in the same manner would be inappropriate. AcSEC concluded that surplus notes meet all of the characteristics of a liability and to record surplus notes in a separate category between liabilities and equity outside of liabilities would not provide users with as relevant information.

Income Statement Presentation

.27 Because surplus notes are presented on the balance sheet as liabilities, interest payments on surplus notes should be recorded as interest expense through operations. This treatment is consistent with current accounting practice for interest expense on debt.

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IP Section 15,000

Issues Papers of the Accounting Standards Division

Issues Papers of the AICPA's Accounting Standards Division are developed primarily to identify financial accounting and reporting issues the division believes need to be addressed or clarified by the Financial Accounting Standards Board. Issues Papers present neutral discussions of the issues identified, including reviews of pertinent existing literature, current practice, and relevant research, as well as arguments on alternative solutions. Issues Papers normally include advisory conclusions that represent the views of at least a majority of the Institute's Accounting Standards Executive Committee.

Issues Papers do not establish standards of financial accounting enforceable under Rule 203 of the Institute's Code of Professional Conduct.

<u>Title</u>	<u>Date Issued</u>
Accounting for Termination Indemnities (superseded by FASB Statement No. 88, <i>Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits</i>)	12/12/78
Accounting for Changes in Estimates	12/15/78
Accounting for Involuntary Conversions (superseded by FASB Interpretation No. 30, <i>Accounting for Involuntary Conversions of Nonmonetary Assets to Monetary Assets</i>)	12/20/78
Accounting for Time Paid But Not Worked (superseded by FASB Statement No. 43, <i>Accounting for Compensated Absences</i>)	1/11/79
The Meaning of "In Substance a Repossession or Foreclosure" and Accounting for Partial Refinancing of Troubled Real Estate Loans Under FASB Statement No. 15 (superseded by AICPA Practice Bulletin No. 7, <i>Criteria for Determining Whether Collateral for a Loan Has Been In-Substance Foreclosed</i>)	1/15/79
Personal Financial Statements (superseded by AICPA <i>Personal Financial Statements Guide</i>)	2/26/79
Project Financing Arrangements (superseded by FASB Statement No. 47, <i>Disclosure of Long-Term Obligations</i>)	2/26/79
Real Estate ADC Costs (superseded by FASB Statement No. 66, <i>Accounting for Sales of Real Estate</i>)	4/27/79

<u>Title</u>	<u>Date Issued</u>
Accounting for Allowances for Losses on Certain Real Estate and Loans and Receivables Collateralized by Real Estate	6/21/79
Joint Venture Accounting	7/17/79
Accounting for Repurchase, Reverse Repurchase, Dollar Repurchase, and Dollar Reverse Repurchase Agreements for Savings and Loans (incorporated into the AICPA Audit and Accounting Guide <i>Audits of Savings Institutions</i>)	8/7/79
Accounting by Investors for Distributions Received in Excess of Their Investment in a Joint Venture (An Addendum to the July 17, 1979 Issues Paper on Joint Venture Accounting)	10/8/79
Accounting for Grants Received From Governments (superseded by IASC International Accounting Standard No. 20, <i>Accounting for Government Grants and Disclosure of Government Assistance</i>)	10/16/79
"Push Down" Accounting	10/30/79
Mortgage Guaranty Insurance (superseded by FASB Statement No. 60, <i>Accounting and Reporting by Insurance Enterprises</i>)	1/8/80
Accounting for Vested Pension Benefits Existing or Arising When a Plant is Closed or a Business Segment is Discontinued (superseded by FASB Statement No. 87, <i>Employers' Accounting for Pensions</i>)	2/5/80
Transfers of Receivables With Recourse (superseded by FASB Statement No. 77, <i>Reporting by Transferors for Transfers of Receivables with Recourse</i>)	3/20/80
Accounting by Lease Brokers (superseded by FASB Technical Bulletin No. 86-2, <i>Accounting for an Interest in the Residual Value of a Leased Asset</i>)	6/20/80
Accounting in Consolidation for Issuances of a Subsidiary Stock	6/30/80
Accounting for the Inability to Fully Recover the Carrying Amounts of Long Lived Assets (superseded by FASB Statement No. 121, <i>Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of</i>)	7/15/80
Intangibles in the Motor Carrier Industry (superseded by FASB Statement No. 44, <i>Accounting for Intangible Assets of Motor Carriers</i>)	8/13/80
Related Party Transactions (superseded by FASB Statement No. 57, <i>Related Party Disclosures</i>)	12/10/80
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Accounting for Installment Lending Activities of Finance Companies (incorporated into the AICPA Audit and Accounting Guide <i>Audits of Finance Companies (including Independent and Captive Financing Activities of Other Companies)</i>)	6/25/81
Accounting for Agricultural Producers and Agricultural Cooperatives (superseded by SOP 85-3, <i>Accounting by Agricultural Producers and Agricultural Cooperatives</i> [see section 10,390])	7/13/81
Accounting for Joint Costs of Multipurpose Informational Materials and Activities of Nonprofit Organizations (superseded by AICPA SOP No. 87-2, <i>Accounting for Joint Costs of Informational Materials and Activities of Not-for-Profit Organizations That Include a Fund-Raising Appeal</i>)	7/16/81
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<u>Title</u>	<u>Date Issued</u>
Accounting for Income Taxes of Stock Life Insurance Companies (superseded by FASB Technical Bulletin No. 84-3, <i>Accounting for the Effects of the Tax Reform Act on Deferred Income Taxes of Stock Life Insurance Enterprises</i>)	7/12/84
Accounting for Key Person Life Insurance (superseded by FASB Technical Bulletin No. 85-4, <i>Accounting for Purchases of Life Insurance</i>)	10/31/84
Accounting by Stock Life Insurance Companies for Annuities, Universal Life, and Related Products and Accounting for Nonguaranteed-Premium Products	11/5/84
Identification and Discussion of Certain Financial Accounting and Reporting Issues Concerning LIFO Inventories	11/30/84
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Section 16,010**Practice Alert 94-1
Dealing With Audit Differences**

February, 1994
(Updated through
December 1, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing audit and accounting literature, the professional experience of the members of the AICPA SEC Practice Section Professional Issues Task Force (PITF) and information provided by the AICPA SEC Practice Section members firms to their own professional staff. The information in this Practice Alert represents the views of the members or the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used by practitioners with the understanding that it be read in conjunction with the professional literature and only as a means of assisting them in meeting their professional responsibilities.

Introduction

.01 Auditors often identify potential adjustments to client accounts as a consequence of audit work performed. Although auditors recognize the importance of identifying and accumulating audit differences, experiences, including those from litigation and peer reviews, suggest that audits can be more effective if auditors pay closer attention to this identification and accumulation process. Specifically, auditors should be mindful that:

- The materiality of audit differences needs to be considered in light of various factors in addition to earnings and stockholders' equity, such as the impact on debt covenants, and analysts' earnings estimates.
- An agreement with management to waive "hard" debit audit differences, including errors, because they have identified offsetting "soft" credit differences can result in problems. Experience has shown that soft differences may not materialize, particularly when they are discovered by management at the last minute after being informed of "hard" differences.
- Numerous audit differences trending in the same direction might suggest bias on the part of management to achieve an earnings forecast. In the worst case, it could be a possible prelude to fraud.
- Accumulated unrecorded audit differences that are not material in the period of origin may be material to financial statements of subsequent periods or when considered in light of changed conditions, including

changes in an entity's management or ownership. This is particularly a consideration where the purchase price is based on book value or a multiple of earnings.

- Audit committees and outsiders (attorneys, regulators, other auditors, etc.) who become aware of waived audit differences sometimes question why those differences were not recorded, especially if they are marginally below materiality thresholds, are errors and/or are clear deviations from generally accepted accounting principles. Audit committees may become upset that they were not previously informed of these differences.

Evaluating Audit Differences

.02 Auditing standards require the auditor to consider whether aggregated uncorrected misstatements, in relation to individual amounts, subtotals or totals in the financial statements, materially misstate the financial statements taken as a whole. Experience indicates that auditors also may need to give closer consideration to the effects on compliance with debt covenants, widely used ratios, financial statement disclosures and whether they may be indicative of an irregularity or illegal act. (See Statement on Auditing Standards (SAS) No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended, paragraphs 34 through 40.) The internal control implications of identified audit differences should also be carefully considered.

.03 Auditors should exercise great care when netting "hard" debit differences and "soft" credit differences because the soft differences may never materialize. For example, the auditor should be careful if a client proposes to reduce inventory obsolescence reserves in order to offset proposed physical inventory test count differences that decrease inventory. Last-minute entries oftentimes need an even higher degree of audit challenge, particularly if they seem to offset unfavorable proposed audit differences.

.04 Also, even when individual accounting estimates included in the financial statements are within acceptable boundaries, the auditor should consider whether the trend of the differences between those estimates and the auditor's best estimates might suggest a possible bias on the part of management. In considering that possible bias, as well as aggregated unadjusted audit differences, the auditor is well advised to bear in mind that the financial statements still could be materially misstated due to differences that have not been detected.

.05 Audit differences are ordinarily accumulated in order to assess their effects on significant components of the financial statements. The accumulated audit differences should include both known differences (e.g., mathematical mistakes, omissions, errors in classifying or recording balances or transactions) and likely differences (e.g., projected total misstatements from sampling applications, differences between an estimate recorded by the client and the auditor's assessment of the closest reasonable amount).

.06 When assessing the materiality of audit differences for a public company, an auditor should consider Staff Accounting Bulletin 99 ("SAB 99"). SAB 99 addresses the concepts of materiality in financial statements. The SAB expresses the views of the SEC staff that "exclusive reliance on certain quantitative benchmarks to assess materiality in preparing financial statements

and performing audits of those financial statements is inappropriate.” The SAB reminds auditors of the need to consider both “quantitative” and “qualitative” factors in assessing an item’s materiality. In SAB 99, the SEC also expresses the view “A matter is material if there is a substantial likelihood that a reasonable person would consider it important.” The SAB provides guidance on the qualitative assessment of materiality in the preparation and audit of financial statements, and reminds registrants of their obligation to maintain accounting records and internal accounting controls as required by the Securities Exchange Act of 1934.

Communicating Audit Differences

.07 Encouraging management to record audit differences, even if they are not material to the current year financial statements, sends a clear message about management’s responsibility for the accounting records and financial statements. There is usually a much greater likelihood management will record appropriate adjustments when those adjustments are brought to their attention early in the audit process. Recording such differences assures that future financial statements will not be affected by an accumulation of unadjusted differences. An accumulation of immaterial unadjusted differences may take on increased significance if an entity or a business segment is sold, a new management team is appointed or if those differences become subject to scrutiny by third parties such as attorneys, regulators or other auditors. In the event that audit differences are not recorded and are assessed as immaterial, the auditor should work towards an agreed plan for management to record such items in the succeeding year.

.08 Finally, auditors are reminded of their obligation to inform the audit committee, or other formally designated oversight body, of recorded and unrecorded adjustments arising from the audit that could, in their judgment, have a significant effect on the entity’s financial reporting process. (See SAS No. 61, *Communication With Audit Committees*, as amended, paragraph 9.)

.09 In early 2000, the Auditing Standards Board will issue SAS No. 89, *Audit Adjustments*, which increases the auditor’s responsibilities for communicating passed audit differences to audit committees. Specifically, the auditor will be required to inform the audit committee about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole. The auditor also will be required to obtain a written representation from management acknowledging that it has considered these financial statement misstatements and concluded that any uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. The SAS will be effective for audits of financial statements for periods beginning on or after December 15, 1999.

[The next page is 50,761.]



Section 16,020**Practice Alert 94-2**
Auditing Inventories—Physical Observations

July, 1994
(Updated through
July 1, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. This document has been prepared by the SEC Practice Section Professional Issues Task Force and is based on the experiences of the individual members of the task force and matters arising from litigation and peer reviews. It has not been approved, disapproved or otherwise acted upon by any committee of the AICPA.

Introduction

.01 The inventories of most commercial entities, especially those of manufacturers or distributors, are material to their financial statements. By its nature, accounting for inventories is complex and generally involves a great deal of detail and is therefore susceptible to inadvertent errors. For similar reasons and the fact that auditors test only a portion of the inventories, there exists more than a low risk of manipulation when management is disposed toward financial statement fraud.

.02 This Alert discusses some ways in which inventory frauds have been perpetrated and presents information that might help prevent such frauds from going undetected. This Alert deals primarily with issues related to the physical existence of inventories. This Alert does not cover matters pertaining to inventory obsolescence, pricing or costing.

Inventory Fraud Schemes/Techniques

.03 Unfortunately, in many cases of inventory fraud, client personnel at various levels knowingly participated and assisted in the scheme. The following are examples of inventory frauds:

- Including inventory that is not what it is claimed to be or valuing nonexistent inventory. Examples are:
 - Empty boxes or “hollow squares” in stacked goods.
 - Mislabeled boxes containing scrap, obsolete items or lower value materials.
 - Consigned inventory, inventory that is rented, or traded-in items for which credits have not been issued.
 - Diluted inventory so it is less valuable (e.g., adding water to liquid substances).

- Increasing or otherwise altering the inventory counts for those items the auditor did not test count.
- Programming the computer to produce fraudulent physical quantity tabulations or priced inventory listings.
- Manipulating the inventory counts/compilations for locations not visited by the auditor.
- Double-counting inventory in transit between locations.
- Physically moving inventory and counting it at two locations.
- Including in inventory merchandise recorded as sold but not yet shipped to a customer (“bill and hold sales”).
- Arranging for false confirmations of inventory held by others.
- Including inventory receipts for which corresponding payables had not been recorded.
- Overstating the stage of completion of work-in-process.
- Reconciling physical inventory amounts to falsified amounts in the general ledger.
- Manipulating the “roll-forward” of an inventory taken before the financial statement date.

Planning Considerations

.04 Even though there are numerous ways inventory frauds can be orchestrated, a well planned audit—appropriately executed with professional skepticism—can thwart many inventory falsification schemes. The audit procedures to be applied stem from and are responsive to the auditor’s assessment of risk (i.e., What could go wrong?). The use of analytical procedures (e.g., review of preliminary high-to-low inventory-value listings or comparison of year-to-year quantities) in planning the audit often helps identify inventory locations, areas or items for specific attention or greater scrutiny during and after the physical count.

.05 To plan an appropriate and effective inventory observation, it is important for the engagement team leaders to have an understanding of the client’s business, its products, its computer processing applications and relevant controls before the physical count occurs, including knowledge of the physical inventory or cycle count procedures and the inventory summarization, pricing and cutoff procedures.

.06 When a client plans to count inventories at various dates or at a date other than that of the financial statements, the early consideration of its business, internal controls and their effectiveness, and cutoff procedures are especially important. Heightened risks or the lack of adequate internal controls may suggest that the inventory should be taken and observed at year end.

.07 An appropriate understanding of the client’s business systems, relevant computer processing applications and inventory procedures helps determine the experience needed by the personnel assigned to observe the physical count and their individual responsibilities. Assigning junior personnel to observe the count at a complex manufacturing operation may or may not be prudent, depending on the extent of on-site supervision provided. Similarly, work-in-process inventory presents completion/valuation issues that may call for a more experienced auditor.

.08 When the observation requires the use of personnel from another office or another CPA firm, adequate planning also enables the auditor to provide clear, comprehensive instructions about the scope of the engagement, the important risk factors, the relevant controls, cutoff procedures, and the expected level of reliance to be placed on internal controls.

The Actual Physical Count

.09

- The risk of inclusion of duplicate or fictitious items is higher in areas and for items not test counted by the auditor. Testing some counts made by all count teams at locations visited and ensuring that hard-to-count items are test counted helps minimize the risk of misstatement.
- Applying analytical procedures to the final priced-out inventory detail can help identify inventory items that might require additional audit scrutiny.
- Although client personnel are often helpful to the auditor making test counts, making test counts of which client personnel are unaware provides added assurance. The auditor can also record the details of some quantities that the auditor did not actually count for comparison with the final inventory listing. Also, the auditor needs to maintain appropriate control over the audit work papers so the client is not aware of the details of the test counts.
- Because the description on a container may not always match the goods inside, it is a good idea to open some containers or packages. Checking for empty containers or “hollow squares” (i.e., spaces between stacks of boxes) and verifying the units of measure on tags or count sheets are meaningful procedures. When observing work-in-process inventory, the auditor also needs to consider the reasonableness of the recorded stage of completion.
- When incorrect counts are observed, the auditor considers the nature and significance of the errors and whether to increase the extent of test counts or expand other procedures. Recounts of particular areas or the work of particular count teams may be necessary.
- Scanning inventory tags or count sheets for unusual or unreasonable quantities and descriptions is a useful technique to verify their propriety. Subsequent to the physical count, it may be desirable to test large or unusual inventory quantities or items with large extended values that were not test counted during the observation.
- The need to monitor the client’s control over the physical count tags or sheets used should not be downplayed or overlooked. Paying close attention to tag/count sheet control procedures helps avoid the inclusion of improper items and ensures appropriate items are included in the final inventory listing.

Multiple Locations

.10 Knowledge of all inventory locations is necessary to prevent the exclusion of any area(s) from audit consideration. Following are a few matters for auditors to consider related to multiple inventory locations.

.11 To help discourage the shifting of inventory from one location to another, the merits of taking the physical inventory at all significant locations at the same time should be considered. When the physical count at each significant location will not be observed, informing management that observations will be performed at some locations without advance notice might help discourage the manipulation of the quantity or quality of the inventory. For locations not visited, the auditor may perform alternative procedures to detect material misstatements. Comprehensive analytical procedures subsequently applied to priced-out inventory summarizations may be one such technique (e.g., the analysis of year-to-year inventories by location, the relationship of inventory to sales levels, etc.). However, the auditor needs to remember that analytical procedures may not always detect erroneous changes in inventory.

Inventories Held for or by Others

.12 Ascertaining whether all inventory items on hand are the property of the client can be difficult in some situations. A client's procedures for identifying, segregating and excluding from inventory goods held on consignment should be considered. Requesting information from selected suppliers about such goods helps in this regard. Once consignment goods have been identified, noting the descriptions, quantities, serial numbers and shipping advice numbers for some items will help the auditor determine whether those items were properly excluded from the client's inventory.

.13 When a client consigns inventory to others or stores merchandise at a third-party location, written confirmation of the goods held is ordinarily obtained directly from the custodian. If such goods are significant in amount, one or more of the procedures discussed in SAS No. 1, section 331, *Inventories*, as amended, paragraph 14, which include visits to such locations and observation of physical counts, may be appropriate.

Use of Specialists

.14 An auditor is not expected to possess the expertise of a specialist trained or qualified in another profession or occupation. Consequently, use of a specialist in certain situations to determine quantities (e.g., stockpiled materials, mineral reserves) or to value special-purpose inventory (e.g., high-technology materials or equipment, chemicals, works of art, precious gems) or to measure the stage of completion of long-term contracts may be appropriate. If the specialist used is affiliated or otherwise has a relationship with the client, the auditor will want to consider the need to perform procedures or otherwise test some or all of the specialist's assumptions, methods and findings. This will provide information about the reasonableness of the findings. Alternatively, the auditor could engage another specialist for this purpose.

Post-Observation Matters

.15 The extent of audit procedures required normally increases when the inventory observation is performed at a date other than the balance sheet date. The extent and nature of the increase depends on the nature of the client's business, the type of inventory, inventory turnover period, the records maintained, the strength of the related internal controls, and the time interval between the observation and the date of the balance sheet. Interim physical

inventories or the client's use of cycle count programs present different audit risks warranting careful assessment of controls, and by extension, different audit tests. This assessment of audit risks and key controls and the focused testing thereof, along with appropriate analytical procedures, are important audit procedures to consider in these circumstances. The guidance in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Substantive Tests Prior to the Balance Sheet Date," is relevant in these circumstances.

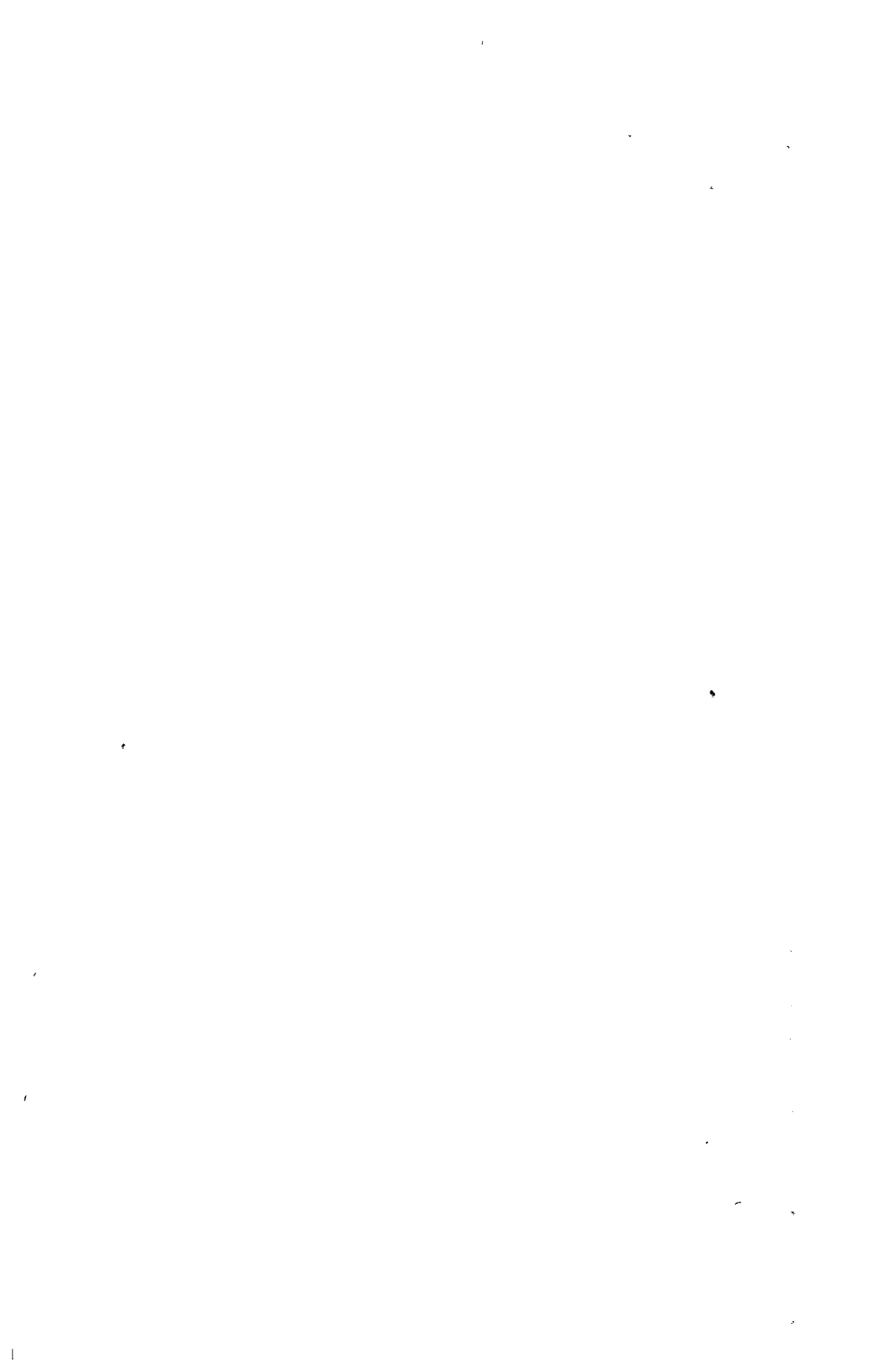
.16 Testing significant items in the reconciliation of the physical inventory to the general ledger helps identify inadvertent errors along with intentional misstatements. Significant reconciling items for those locations where the physical counts were not observed by the auditor generally merit scrutiny. Goods in-transit and inventory transfers between affiliates, locations or departments are tested to ascertain their existence and to determine the propriety of their inclusion or exclusion.

Conclusion

.17 Unfortunately, there are no foolproof methods for assuring that all inventory counts are free from inadvertent or intentional misstatement. No audit will necessarily detect all fraudulent activity, especially when collusion to mislead the auditors occurs among client personnel or with third parties. However, understanding the client's business, its count procedures and controls and a resulting careful assessment of where and how quantity error might occur helps reduce the risk of inadvertent or intentional misstatement. Appropriate planning for the physical inventory observation together with healthy audit skepticism can effectively reduce the incidence of inventory misstatements.

.18 This Practice Alert is not a complete list of all audit procedures, nor is every procedure discussed herein applicable in all circumstances. Additional information on this important subject is provided in the AICPA's Auditing Procedures Study, *Audits of Inventories* (Product No. 021045MJ). The AICPA Order Department may be reached at (888) 777-7077.

[The next page is 50,771.]



Section 16,030**Practice Alert 94-3****Acceptance and Continuance of Audit Clients**

September, 1994
(Updated through
July 1, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. This document has been prepared by the SEC Practice Section Detection and Prevention of Fraud Task Force. It has not been approved, disapproved or otherwise acted upon by any committee of the AICPA.

Introduction

.01 In order to minimize the likelihood of association with a client whose management lacks integrity, Statement on Quality Control Standards No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, paragraph 14 (applicable to auditing, accounting and review services), provides that "policies and procedures should be established for deciding whether to accept or continue a client relationship and to perform a specific engagement for that client" (paragraph 14), to minimize the likelihood of the specific policies and procedures established and the nature and extent to which they may be documented may vary significantly from firm to firm.

.02 The following discussion highlights matters that a firm may wish to consider in connection with establishing policies and procedures for client acceptance and continuance. The extent to which a firm may choose to employ any of the following is, with the exception of certain procedures required by generally accepted auditing standards, largely a matter of professional judgment. The discussion of specific policies and procedures is intended to be thought provoking and useful to a firm in assessing the particular client acceptance and continuance policies and procedures it may choose to employ in its practice.

.03 Throughout the process, from initial consideration about accepting or continuing a client to issuance of an audit report, auditors are faced with risk. This risk can be thought of as having three components:

- The entity's business risk—The risk that the entity will not survive or will not be profitable.
- The auditor's business risk—The risk to the auditor from association with the client, consisting of the risk of potential litigation costs and the related effect on the auditor's reputation and the risk of other costs (not related to litigation) such as the effects on fee realization.

- The auditor's audit risk—The risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated.

The auditor's business risk may be controlled in part through policies and procedures established for deciding whether to accept or continue a client. Selectivity in accepting and retaining clients represents a prudent business decision on the part of auditors—not a conclusive judgment as to the integrity or lack thereof of client management.

.04 Unfortunately, it may be very difficult to identify when a potential or existing client may present a significant risk to the CPA firm because of heightened risk of fraudulent financial reporting or unwarranted litigation stemming from the entity's business risk. The establishment of a periodic evaluation of all of the relevant risk factors may serve to heighten professional skepticism and focus attention on the client association decision.

Client Acceptance

.05 A statement of general firm philosophy is an appropriate accompaniment to specific client acceptance policies and procedures. The firm may, for example, want to state that clients accepted by the firm should be engaged in legitimate pursuits and should not present undue business risks to the firm, including damage to the firm's reputation. For example, the firm may not wish to be associated with a prospective client that presents an unusually high risk of being involved in litigation or other disputes, even in situations where it appears that the quality and propriety of the auditor's services can clearly be demonstrated to third parties.

.06 A client acceptance assessment should consider the integrity of the persons who act in management capacities at the client. Consequently, satisfactory responses to inquiries regarding the integrity of management should be a principal objective of client acceptance procedures. Inquiries about individuals may be supplemented by background checks and review of information published in the press or business journals.

.07 The following are procedures a firm may consider performing in connection with a client acceptance assessment:

1. Obtain an understanding of the client's business and operations. Consideration should be given to reading available financial information regarding the prospective client such as annual reports, registration statements, Form 10-K, other reports to regulatory agencies and income tax returns.
2. Inquire as to the general reputation of high ranking employees, influential directors and shareholders, as well as the entity itself. Carefully consider any matters that may negatively reflect on management's integrity, ability and attitude. Such inquiries may be directed to the prospective client's bankers, legal counsel, underwriters, and others in the business community. Background checks obtained by investigative firms may also be useful.
3. Consider management's response to observations about or suggestions for improvements in internal controls made by the predecessor auditor and/or the internal auditor.

4. Consider the composition and autonomy of the Board of Directors and the Audit Committee, including the number of independent outside directors.
5. Communicate with the predecessor auditor in accordance with the provisions of Statement on Auditing Standards (SAS) No. 84, *Communications Between Predecessor and Successor Auditors*. Inquiries should be directed to the integrity of management and the reasons for the change in auditor. The following situations should be carefully considered in assessing whether to accept a client:
 - There has been a disagreement with the previous auditor over accounting principles or practices; financial statement disclosures; auditing scope; or the Form 8-K discloses a reportable event as defined in Securities and Exchange Commission Regulation S-K.
 - The previous auditor resigned or declined to stand for re-election or there is no clear reason for the cessation of the client relationship.
 - Access to the predecessor auditor's working papers has been denied.
 - Other CPA firms have declined to serve the prospective client.
 - There appears to be evidence of "opinion shopping."
6. Read the Form 8-K (or other filing, if applicable) reporting the termination of the predecessor auditor, including the predecessor auditor's response to Form 8-K, to identify disagreements, reportable events and other matters that require discussion with the predecessor auditor, legal counsel or management.
7. Consider whether any financial interests or relationships exist that would impair the appearance of the firm's independence from the client and preclude its expression of an opinion on the entity's financial statements. The firm should consider Rule 101 of the AICPA Code of Professional Conduct. For clients that are public companies, the firm should also consider the requirements of the SEC.
8. Consider whether the services to be provided are compatible with the CPA firm's policies and whether qualified personnel are available, including those having appropriate industry expertise, and will be able to assist in providing the necessary services.
9. Consider any potential conflicts of interest that could result from the acceptance of a client.
10. Consider the willingness and ability of the prospective client to pay an acceptable fee.
11. Consider the significance of specific risk factors identified as a result of the above procedures. (Examples of risk factors are included below.)

Client Continuance

.08 Because of rapid changes in the business environment, active consideration of whether to continue to serve a client may help to reduce the auditor's

business risk. The same matters considered when the client was accepted may be reconsidered in light of the cumulative experience with the client in order to highlight issues such as management integrity, changes in management behavior, deteriorating financial condition, or rapidly changing operational conditions. Such an evaluation also may focus the CPA firm on changes in engagement risk and may provide an opportunity to consider methods, short of cessation of the client relationship, to reduce audit risk to acceptable levels.

.09 Firms may find that an annual client continuance evaluation program provides an effective framework for active consideration of client continuance. The annual client continuance evaluation program may be conducted by having each engagement team perform an evaluation considering the relevant factors in light of their cumulative experience with and knowledge of the client. It also may be helpful to have an independent review of the engagement team's evaluation performed by an independent firm committee, a partner not associated with the engagement or the managing partner. Such an approach allows a CPA firm to evaluate the cumulative risk posed by the sum of its clients. In addition, an independent review team or reviewer may bring a broader base of experience and perspective to the evaluation and adds an element of consistency across the CPA firm.

.10 Client continuance evaluations are most effectively completed before entering into an engagement, signing an engagement letter, or beginning significant work on an engagement. Although the client continuance evaluation program may be conducted annually, auditors should also be cognizant throughout the audit, that circumstances may be encountered that would suggest consideration of whether the client relationship should be terminated.

Engagement Risk Factors

.11 In assessing whether to accept or continue a client relationship, the firm should consider and address matters related to (1) the entity's business risk, (2) the auditor's business risk, and (3) the auditor's audit risk. Certain matters or factors may be more significant than others. Many of the individual factors listed below may be present in entities that do not present increased engagement risk and that are not candidates for auditor rejection or resignation. However, a combination of the factors has been present in a number of the client business failures of the past. Decisions regarding client acceptance and continuation require the exercise of professional skepticism and judgment. In order to assist auditors in making the difficult client acceptance and continuance decisions, some CPA firms have assigned various weights to the factors the CPA firm believes are more critical to the auditor's business risk. A weighted, "scoring" system can be used to assist the auditor and the CPA firm in evaluating the auditor's business risk. Other CPA firms have developed a more extensive list of factors. The following list is not intended to be all inclusive.

.12 Circumstances that may lead to a higher assessment of engagement risk include:

1. Entity's Business Risk

- Management:
 - Engages in activities indicative of a lack of integrity.
 - Is prone to engage in speculative ventures or accept unusually high business risks.

- Displays a poor attitude toward compliance with outside regulatory or legislative obligations.
 - Engages in complex transactions or innovative deals that make the determination of the effects on the financial statements difficult to assess or highly subjective.
 - Lacks a proven track record.
 - Is evasive, uncooperative or abusive to the audit team.
 - The Entity:
 - Has products that are new and unproven.
 - Depends on a limited number of customers or suppliers.
 - Is experiencing a deteriorating financial condition or liquidity crisis.
 - Is subject to uncertainties that raise substantial doubt about its ability to continue as a going concern.
 - Operates in countries where business practices are questionable.
 - Has an inadequate capital base or is highly leveraged.
 - Is experiencing difficulty in meeting restrictive debt covenants.
 - Generates negative cash flows from operations but reports operating profits.
 - Has publicly traded debt outstanding that is below investment grade.
 - Is a low tier firm in an emerging or maturing industry where weak competitors are exiting the market.
 - Is subject to unpredictable changes in price and availability of product inputs that cause significant variance in profitability.
 - Is vulnerable to rapidly changing technology.
 - Is investing cash from short-term borrowings in long-term assets.
 - The Industry:
 - Is undergoing rapid change.
 - Is subject to high competition, market saturation, product obsolescence, or declining demand.
 - Has high operating leverage demonstrated by high fixed costs and low variable costs.
 - Is highly cyclical or counter cyclical.
 - Has a low entry barrier.
 - Is facing regulations that will adversely impact profitability throughout the industry.
2. Auditor's Business Risk
- The entity is prone to a high number of lawsuits or controversies.
 - There are frequent changes in the entity's auditors.

- The entity plans to engage in an initial public offering or use the financial statements to engage in a debt or equity offering.
- The financial statements will be used in connection with an acquisition or disposal of a business or segment.

3. Auditor's Audit Risk

The auditor should follow SAS No. 47, *Audit Risk and Materiality in Conducting an Audit*, as amended, which provides guidance on the auditor's consideration of audit risk when planning and performing an audit of financial statements. Examples of factors that may increase audit risk include:

- Operations that are dominated by a single individual.
- Undue emphasis on achieving earnings per share; maintaining the market price of the company's stock; or meeting earnings projections.
- Unreliable processes for making accounting estimates or questionable estimates by executives.

Unrealistic budget levels that encourage unrealistic objectives.

- A high volume of significant year-end transactions.
- Compensation based to a significant degree on reported earnings.
- An unnecessarily complex corporate structure.
- Prior-year financial statements that were restated for correction of an error or irregularity.
- Attempts by management to reduce the scope of the audit.
- Substantial litigation involving the entity's business practices.
- Material weaknesses or other reportable conditions in the internal control structure.
- Significant and unusually complex related party transactions.
- Affiliates that are unaudited or audited by others.
- Management espouses aggressive accounting principles.
- Understaffed accounting department or inexperienced personnel.
- Financial reports not prepared on a timely basis.

[The next page is 50,791.]

Section 16,040

Practice Alert 95-1 ***Revenue Recognition Issues***

January, 1995
(Updated through
October 15, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. This document has been prepared by the SEC Practice Section Professional Issues Task Force and is based on the experiences of the individual members of the task force and matters arising from litigation and peer reviews. It has not been approved, disapproved or otherwise acted upon by any committee of the AICPA.

Introduction

.01 A substantial portion of litigation and SEC investigations involving financial reporting and cases coming before the AICPA Professional Ethics Executive and Quality Control Inquiry Committees concerns some form of revenue recognition issue. Although some of these situations involve accounting for large, complex transactions, many result from improper accounting for routine sales recorded in the ordinary course of business. Therefore, auditors need to pay particular attention to warning signals that may indicate additional audit risk and respond with appropriate professional skepticism and possible additional audit procedures.

.02 This Practice Alert is intended to remind auditors of conditions that can be indicative of increased audit risk with respect to improper and unusual revenue practices. It suggests ways in which auditors may reduce the risk of failing to detect such practices. The Alert focuses on revenue recognition issues as they relate to sales of products and services. It is not intended to and does not provide comprehensive guidance on the design or performance of audit procedures.

Improper and Unusual Revenue Recognition Practices

.03 Auditors need to be alert to the possibility that client personnel at various levels may knowingly participate and assist in schemes designed to overstate revenue. In some cases they have been aided by customers and suppliers or other third party participants. Improper and unusual revenue recognition practices vary by industry. Following are some examples of improper and unusual revenue transactions:

- Sales in which the customer's obligation to pay for the merchandise/service depends on:
 - Receipt of financing from another (third) party;
 - Resale to another (third) party (i.e., consignment sale);
 - Fulfillment by the seller of material unsatisfied conditions; or
 - Final acceptance by the customer follows an evaluation period.
- Sales in which substantial uncertainty exists about either collectibility or the seller's ability to comply with performance guarantees.
- Sales that require substantial continuing vendor involvement after delivery of merchandise (e.g., software sales requiring installation, debugging, extensive modifications, other significant support commitments, etc.).
- Shipments to and held by a freight forwarder pending return to the company for required customer modifications.
- Sales of merchandise shipped in advance of the scheduled shipment date without the customer's agreement or assent.
- Pre-invoicing of goods in process of being assembled or invoicing prior to, or in the absence of, actual shipment.
- Shipments made after the end of the period (i.e., books kept open to record revenue for products shipped after period end).
- Transactions involving the application of the percentage-of-completion method of accounting. (There have been instances in which overly optimistic percentage-of-completion estimates were used, reasonably dependable estimates could not be made or a historical basis for making estimates did not exist.)
- Sales not based on actual (firm) orders to buy.
- Shipments made on cancelled or duplicate orders.
- Shipments made to a warehouse or other intermediary location without the instruction of the customer.
- Sales billed to customers prior to delivery and held by the seller ("bill and hold" or "ship in place" sales). (There have been cases in which payments have not been required for a lengthy period and cases in which delivery to the customer never took place.)
- Sales on terms that do not comply with the company's normal policies.
- Transactions with related parties.
- Barter transactions.
- Significant, unusual transactions near year-end.
- Partial shipments when the portion not shipped is a critical component of the product (e.g., shipment of computer peripherals without the central processing unit).

Planning Considerations

.04 Techniques used to recognize revenues improperly can be quite sophisticated. To reduce risk in this area, the audit needs to be planned and then executed with an appropriate degree of professional skepticism.

.05 In planning an audit of revenue transactions, an auditor needs a sufficient understanding of the client's industry and business, its products, its internal control structure over revenue, and its accounting policies and procedures, particularly as they relate to revenue recognition. This understanding should include the procedures for receiving and accepting orders, shipping goods, relieving inventory, and billing and recording sales transactions. It also involves an understanding of the computer applications and key documents (e.g., purchase orders, shipping reports, bills of lading, invoices, credit memos, etc.) used during the processing of revenue transactions.

.06 An understanding of the revenue cycle is particularly important when the company has new product or service introductions or begins new sales arrangements. New products may not work as envisioned or customer acceptance may not be as expected. Sales terms might differ from the company's customary terms and both the client's employees and the auditor may need to obtain an understanding of new procedures.

.07 This knowledge base provides a perspective or "mindset" for determining the nature, timing, and extent of audit procedures to be applied. For example, a company operating in a declining industry or one characterized by more than infrequent business failures ordinarily will present different audit considerations and, therefore, could require different or more extensive audit procedures than a company operating in a healthy industry. Similarly, the risk of management misrepresentation may be greater when management's compensation is based to a significant degree on reported earnings or when management places undue emphasis on meeting analysts' earnings projections.

.08 Risk also may be heightened when there are frequent disputes or disagreements with management about the "aggressive" application of accounting principles. Statement on Auditing Standards No. 82, *Consideration of Fraud in a Financial Statement Audit*, provides additional factors to consider when assessing the risk of material misstatements or management misrepresentation.

.09 A proper understanding of a client's business, its accounting policies and procedures, and the nature of its transactions with customers can also be helpful in assessing the extent of experience or supervision required of the personnel assigned to audit the revenue transactions. Unusual or complex sales contracts may call for consideration by more experienced engagement personnel.

.10 Moreover, the performance of appropriate, well-planned analytical procedures during the audit planning process and in executing the audit itself (such as, a comparison of sales to corresponding periods of the prior year and to budget; a review of monthly and/or quarterly analyses of sales volume; and a ratio analysis of sales in the last month to total sales) may help the auditor identify situations that warrant additional consideration. A company with constantly increasing sales that "always meets or exceeds" budgeted sales targets may deserve extra attention. When a substantial portion of the company's sales occur very near the year-end or quarter-end, extra caution in auditing revenue transactions may be appropriate. Also, individually significant revenue transactions, which could be designed to ease short-term profit concerns, may merit specific attention. Auditors need to examine such transactions and obtain an understanding of their business purpose to evaluate whether revenue recognition is appropriate.

Confirmations and Representations

.11 Unusual or complex revenue transactions may increase audit risk. Consequently, the auditor should consider the need to perform additional audit procedures to assess the propriety of revenue recognition. Examples of such additional audit procedures may include confirmation of sales terms, review of sales contracts, or the use of a specialist to interpret contractual agreements.

.12 Standard confirmation requests (confirming only the outstanding balance) alone do not always provide sufficient audit evidence to determine that only appropriate revenue transactions have actually been recorded. Confirmations can be designed to help the auditor solicit information from customers about payment terms, right-of-return privileges, or other significant risks retained by the seller. In determining the information to confirm, an understanding of the client's arrangements and transactions with its customers is essential. If the auditor is aware of unusual arrangements or transactions (e.g., "bill and hold" or consignment sales), confirmations can be used to corroborate the terms of the agreements and inquire about the existence of any oral modifications or undocumented "side-agreements" (e.g., unusual payment terms, liberal rights of return). When the arrangements are unusual, auditors are well advised to consider the business purpose of the transactions from the perspectives of both the seller and the buyer, and evaluate responses to inquiries with appropriate professional skepticism. Also, because of the increased risk presented by individually significant revenue transactions, the auditor should consider confirming the terms of those sales.

.13 Although representations from management are not a substitute for the application of those audit procedures necessary to afford a reasonable basis for an opinion on the financial statements, it might be useful to obtain written representations concerning the terms and conditions of unusual or complex sales agreements. Such representations may include things such as contingencies that affect the obligation of customers to pay for merchandise purchased. This is important when it is common industry practice to provide customers with certain rights of return or other privileges (e.g., in high-technology enterprises).

Conclusion

.14 No audit can be designed to provide absolute assurance that all revenues recorded by the client are appropriate or that fraudulent financial reporting is discovered. However, an awareness of conditions that increase audit risk, along with an appropriate skeptical response to unusual items identified during the audit, can help auditors increase the likelihood that either inadvertent or intentional material misstatements of revenue will be detected.

[The next page is 50,801.]

Section 16,050

Practice Alert 95-3 **Auditing Related Parties and** **Related-Party Transactions**

November, 1995
(Updated through
July 1, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. This document has been prepared by the SEC Practice Section Professional Issues Task Force and is based on the experiences of the individual members of the task force and matters arising from litigation and peer reviews. It has not been approved, disapproved or otherwise acted upon by any committee of the AICPA.

Introduction

.01 One of the more important and yet, more difficult, aspects of a financial statement audit is the identification of related parties and transactions with related parties. This aspect of the audit is important because of (1) the requirement under generally accepted accounting principles to disclose material related-party transactions and certain control relationships, (2) the potential for distorted or misleading financial statements in the absence of adequate disclosure, and (3) the instances of fraudulent financial reporting and misappropriation of assets that have been facilitated by the use of an undisclosed related party. Further, while not discussed in more detail in this Practice Alert, it is incumbent upon the auditor to assess the propriety of the accounting for material related-party transactions in accordance with their substance.

.02 Related parties and related-party transactions are difficult to audit for several reasons. First, transactions with related parties are not always easily identifiable. For example, a series of sales in the normal course of business, individually insignificant, could be executed with an undisclosed related party that in total could be material. Second, although other procedures are ordinarily performed, the auditor relies primarily upon management and principal owners to identify all related parties and related-party transactions. Third, such transactions may not be easily tracked by a company's internal control.

.03 Generally accepted accounting principles (FASB Statement No. 57, *Related Party Disclosures*) define related parties and require certain disclosures regarding material related-party transactions, as well as the nature of control relationships that could result in operating results or financial positions significantly different from those that would have been achieved in the absence of such relationships, regardless of whether there were transactions between or among the related parties. Generally accepted auditing standards

(Statement on Auditing Standards (SAS) No. 45, *Omnibus Statement on Auditing Standards—1983*, “Related Parties”) provide guidance on procedures that should be considered by the auditor to identify related-party relationships and transactions, and to satisfy him- or herself that such relationships and material transactions are properly accounted for and adequately disclosed in the financial statements.

.04 The detailed requirements of generally accepted accounting principles and generally accepted auditing standards are not discussed here. The purposes of this Practice Alert are twofold: first, to focus on events that may indicate transactions with undisclosed related parties are occurring; and, second, to offer suggestions on how to respond to those events.

Events That May Indicate Transactions With Undisclosed Related Parties

.05 In the hands of the unscrupulous, an undisclosed related party is a powerful tool. Using controlled entities, principal shareholders or management can execute transactions that improperly inflate earnings by masking their economic substance or distort reported results through lack of disclosure, or can even defraud the company by transferring funds to a conduit related party and ultimately to the perpetrators. Examples of events that may indicate transactions with undisclosed related parties are occurring include:

- Sales without substance, including funding the other party to the transaction so that the sales price is fully remitted.
- Sales with a commitment to repurchase that, if known, would preclude recognition of all or part of the revenue.
- Accruing interest at above market rates on loans.
- Loans to parties that do not possess the ability to repay.
- Advancing company funds that are subsequently transferred to a debtor and used to repay what would otherwise be an uncollectible loan or receivable.
- Services or goods purchased from a party at little or no cost to the entity.
- Borrowing at below market rates of interest.
- Loans advanced ostensibly for a valid business purpose and later written off as uncollectible.
- Payments for services never rendered or at inflated prices.
- Sales at below market rates to an unnecessary “middle man” related party, who in turn sells to the ultimate customer at a higher price with the related party (and ultimately its principals) retaining the difference.
- Purchases of assets at prices in excess of fair market value.

Responding to Related Parties and Related-Party Transactions Not Voluntarily Disclosed by Management

.06 *Assessing risk.* The number one rule for potentially identifying related parties and related-party transactions that management does not disclose to the independent auditor is simply to be alert to that possibility. Generally accepted auditing standards (SAS No. 82, *Consideration of Fraud in*

a *Financial Statement Audit*) require the auditor to “assess the risk of material misstatement of the financial statements due to fraud and consider that assessment in designing the audit procedures to be performed.” This assessment is based on the auditor’s consideration of certain risk factors that relate to misstatements that may arise from fraudulent financial reporting and misappropriation of assets. Risk factors associated with fraudulent financial reporting may be grouped among: (1) management’s characteristics and influence over the control environment, (2) operating characteristics and financial stability, and (3) industry conditions. When considering risk factors relating to an entity’s operating characteristics and financial stability, the auditor may conclude that related parties and/or related party transactions are a potential source for material misstatement. Following are examples of indicators that may cause the auditor to conclude that such a potential exists:

- Complex corporate structure, possibly with restrictions on the disclosure of ownership or the identity of shareholders.
- Audit responsibilities for entities that have material intercompany transactions with one another divided among two or more auditing firms, or in which one of the entities is not audited.
- Highly complex business practices that enhance the ability of management to mask their economic substance.
- The existence of unique, highly complex, and material transactions close to year-end that pose difficult “substance over form” questions.

.07 Responding to risk. When the auditor concludes there is a significant risk of material misstatement due to fraud or other errors, he or she might respond in a number of ways, such as assigning more experienced staff to the engagement. Ordinarily, higher risk requires more experienced personnel or more extensive supervision by the auditor with final responsibility for the engagement during both the planning and the conduct of the engagement. Higher risk also may cause the auditor to expand the extent of procedures applied, apply procedures closer to or as of the balance sheet date, or modify the nature of procedures to obtain more persuasive evidence. According to generally accepted auditing standards, evidential matter obtained from independent outside sources provides a greater assurance of reliability than evidence secured solely within the company (SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31*, Evidential Matter, paragraph 21a). Higher risk will also ordinarily cause the auditor to exercise a heightened degree of professional skepticism in conducting the audit.

.08 Without regard to the auditor’s risk assessment, the auditor would perform many, if not all, of the procedures suggested in SAS No. 45 for determining the existence of related parties. These include evaluating the company’s procedures for identifying related parties, requesting from management the names of all related parties, reviewing SEC and other regulatory filings for names of possible related parties, reviewing stockholder listings of closely held companies, inquiring of predecessor, principal, or other auditors of related entities, and reviewing material investment transactions which might create related parties.

.09 The auditor would also perform many, if not all, of the procedures suggested in SAS No. 45 for identifying transactions with known related parties. Among the suggested procedures are: reviewing minutes of board of directors meetings; reviewing conflict-of-interest statements; reviewing the extent and nature of business transacted with major customers, suppliers,

borrowers, and lenders; reviewing the accounting records for large, unusual, or nonrecurring transactions or balances; and reviewing correspondence and invoices from law firms for indications of possible related parties and related-party transactions.

.10 When deciding which related-party procedures to perform during the audit, the auditor may want to consider in that determination the results of an evaluation of the effectiveness of the company's procedures for identifying related parties and related-party transactions and the company's controls over management's ability to enter into related-party transactions. Generally accepted auditing standards (SAS No. 85, *Management Representations*) require that a written representation letter be obtained from management and states that such letter should ordinarily cover transactions with related parties. Although not required by SAS No. 85 or suggested by SAS No. 45, the auditor may want to obtain written representations from the entity's board of directors about whether they or any other related parties engaged in transactions with the entity during the period under audit.

.11 The related-party procedures performed would be considered in relationship with the other audit procedures performed in response to the overall risk assessment on the audit. Many of the related-party procedures suggested in SAS No. 45, such as reviewing minutes, serve more than one audit objective. When performing other procedures on the audit, the auditor may encounter information that can assist him or her in identifying the existence of related parties and related-party transactions. Therefore, it is important that information about known related parties be communicated to all engagement team members, including those performing work at other locations. The development during the audit planning process of a list of related parties could serve as the vehicle of this communication.

.12 When performing the audit, all team members should be alert for transactions that might involve undisclosed related parties. When events come to the auditor's attention that may indicate transactions with related parties, the performance of additional audit procedures related to the other party to the transaction may be necessary to determine whether an undisclosed relationship exists. Such procedures could include confirming details of the transaction with the principals of the other party or, with the other party's permission, its auditors as to the nature of any relationship with the company and its management. In complex situations, the auditor may need to discuss the related-party transaction with other outside parties such as bankers or legal counsel who are familiar with the transaction or request to inspect evidence in the possession of such persons and/or the other party.

.13 When an undisclosed related party has been identified, the audit team would assess whether management's failure to disclose was merely an oversight or a deliberate attempt to mask the relationship. If the latter, the auditor would reassess the overall audit scope and the ability to rely on management's representations in other areas. If the auditor believes he or she can no longer trust management, the best course of action may be to withdraw from the engagement. The auditor may want to consult with legal counsel in these circumstances.

Conclusion

.14 Identifying related parties and material related-party transactions is a key component of any audit. The likelihood of identifying undisclosed related

parties and related-party transactions is enhanced when the auditor maintains throughout the audit an awareness for events that may indicate such undisclosed parties or transactions. By following up on such events and determining whether they are the result of related parties, the auditor enhances the likelihood that related-party transactions are properly accounted for and disclosed in the financial statements, thereby providing users with relevant information for decision-making.

[The next page is 50,811.]

Section 16,060**Practice Alert 96-1****The Private Securities Litigation Reform Act
of 1995**

May, 1996
(Updated through
July 1, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. This document has been prepared by the SEC Practice Section Professional Issues Task Force. It has not been approved, disapproved or otherwise acted upon by any committee of the AICPA.

Introduction

.01 As 1995 drew to a close, the Private Securities Reform Act of 1995 (the Act) became law. This Act provides welcome liability reform for both Securities and Exchange Commission (SEC) registrants and those who provide services to SEC registrants. The Act not only changes the way that plaintiffs may bring lawsuits, but also imposes certain obligations and requirements on SEC registrants and their auditors. This Practice Alert discusses two sections of the Act (Fraud Detection and Disclosure and the Safe Harbor for Forward-Looking Statements) and how they affect auditors in performing audits and other services.

Fraud Detection and Disclosure

.02 The Fraud Detection and Disclosure section of the Act reaffirms the independent accountant's responsibility regarding illegal acts as described in both Statement on Auditing Standards (SAS) No. 53, *The Auditor's Responsibility to Detect and Report Errors and Irregularities*, and SAS No. 54, *Illegal Acts by Clients*. The Act requires that audits of financial statements conducted pursuant to the Securities Exchange Act of 1934 include generally accepted auditing standards procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts.

.03 An illegal act is defined as an "act or omission that violates any law, or any rule or regulation having the force of law." Under the Act, as under current practice, if the auditor "detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred," the

auditor then (1) determines whether it is likely that an illegal act has occurred; (2) evaluates the possible effects of the illegal act on the issuer's financial statements; and (3) promptly informs the appropriate level of management and assures that the audit committee or board of directors is adequately informed with respect to the illegal act, unless it is clearly inconsequential.

Private Securities Reform Act of 1995

.04 The Act contains new reporting requirements that will come into play if the auditor:

- Determines that the audit committee or the board of directors is adequately informed with respect to illegal acts that "have been detected" or have otherwise come to the auditor's attention during the course of the audit, and
- Concludes that the illegal act has a material effect on the financial statements;
- Senior management has not taken, and the board has not caused it to take, "timely and appropriate remedial actions";¹ and
- The failure to take remedial action "is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement."

In that instance the auditor "shall, as soon as practicable," report its conclusions directly to the board.

.05 Under the new reporting requirements added by the Act, an issuer that receives the report described above must notify the SEC within one business day after receiving the report and must send a copy of that notice to the auditor. If the auditor does not receive the notice within the one day period, it must, whether or not it resigns, furnish a copy of its report (or documentation of an oral report) to the SEC within one business day after the failure of the issuer to give its required notice. Auditors are protected from liability in a private action "for any finding, conclusion, or statement" expressed in a report required of them under this provision. The SEC staff has stated that until the SEC adopts reporting requirements to implement this rule, any auditor faced with filing such a notice should contact the SEC staff at (202) 942-4400.

.06 The Fraud Detection and Disclosure section of the Act also reemphasizes the requirements that audits include:

- Procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein. Note that appropriate procedures for identifying related parties and the related disclosure requirements are contained in SAS No. 45, *Omnibus Statement on Auditing Standards—1983*, "Related Parties," and Financial Accounting Standard No. 57, *Related Party Disclosures*. In addition, related party issues are discussed in Practice Alert No. 95-3, *Auditing Related Parties and Related Party Transactions* [section 16,050]; and

¹ "Remedial action" for this purpose may include: (1) taking appropriate disciplinary actions; (2) establishing policies, internal controls, and related monitoring procedures designed to safeguard against the recurrence of such illegal acts; and (3) as appropriate, reporting the effects of the illegal acts in the financial statements. SAS No. 54, paragraphs 17 and 18.

- An evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year. This provision of the Act is covered by SAS No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (as amended by SAS No. 77, *Amendments to Statements on Auditing Standards No. 22, Planning and Supervision, No. 59, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern, and No. 62, Special Reports*).

Safe Harbor for Forward-Looking Statements

.07 The Act amends the Securities Act of 1933 and the Securities Exchange Act of 1934 by creating a new "safe harbor" for forward-looking statements made by an issuer, persons acting on behalf of the issuer, and any outside reviewer retained by the issuer to make a statement on the issuer's behalf. Under the Act, the term "forward-looking information" means:

- a. A statement containing a projection of revenues, income, earnings per share, capital expenditures, dividends, capital structure, or other financial items;
- b. A statement of management's plans and objectives for future operations, including plans or objectives relating to the issuer's products or services;
- c. A statement of future economic performance, including any statement contained in management's discussion and analysis of financial condition or the results of operations included pursuant to SEC rules and regulations;
- d. Any statement of the assumptions underlying or relating to any statement described in a., b., or c.;
- e. Any report issued by an outside reviewer retained by the issuer, to the extent that the report assesses a forward-looking statement made by the issuer; or
- f. A statement containing a projection or estimate of such other items as may be specified by SEC rules or regulations.

.08 However, the Act provides for certain exclusions to the safe harbor protection, most notably for forward-looking statements made in connection with an initial public offering or a tender offer, and forward-looking statements included in financial statements prepared in accordance with generally accepted accounting principles (historical financial statements). Additional exclusions are detailed in the Act.

.09 The safe harbor protection covers both written and oral forward-looking statements made by the registrant or those acting on the registrant's behalf. In addition, there is no requirement under the Act to update the forward-looking statements. To be protected by the Act, a written or oral forward-looking statement must:

1. Be identified as a forward-looking statement; and
2. Be accompanied by meaningful (not boilerplate) cautionary language identifying important factors that might cause the actual results to differ materially from those in the forward-looking statement.

If these conditions are not met, liability may be attached only if the plaintiff can prove that the forward-looking statement was made with actual knowledge that the statement was false or misleading.

.10 Oral forward-looking statements and cautionary language can satisfy the requirement of identifying important factors by making reference to a readily available written document, including a filing with the SEC.

.11 Companies may request that auditors advise them in the development and presentation of forward-looking statements, possibly extending to attesting to their assertions regarding such information. Other companies may only seek informal input in the process. Attempting to provide guidance for all situations is difficult, but the following should be helpful in relation to the level of service requested.

- *No substantive attention requested by the registrant*

When no substantive work has been requested, the auditor's responsibility for forward-looking statements included in documents containing audited financial statements is discussed in SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*, and SAS No. 37, *Filings under Federal Securities Statutes*. Basically, SAS No. 8 and SAS No. 37 require auditors to read other information, including any forward-looking statements, cautionary language, and important factors, and to consider whether such information, or the manner of its presentation, is materially inconsistent with the financial statement information or the manner of its presentation. This responsibility, of course, does not include opining on whether or not the disclosure meets the requirements of the safe harbor or any reasonableness or other review of the forecasted information. To assist client executives and directors in understanding this responsibility, auditors should discuss with them the auditor's responsibility for such information under generally accepted auditing standards as part of the required communications under SAS No. 61, *Communication with Audit Committees*, as amended, paragraph 10. The auditor may wish to add language to the engagement letter or other communications to clarify this understanding.

- *Substantive attention requested by the client, not leading to a report on such information*

The company may engage the auditor to consult on the forward-looking statement, cautionary language, and important factors. Because of the subjective nature of this consultation, the extent of the auditor's involvement should be clarified with the company. In addition, documenting the discussions held and having an engagement letter are strongly encouraged. In any event, the auditor should be aware of the SEC's position that accountants who assist in the preparation of a forecast may not be independent from an SEC perspective and may not report on the forecast.

- *Substantive attention requested by the client, leading to a report on such information*

The company may request the auditor to examine or perform agreed-upon procedures on the forward-looking statement, cautionary language, and important factors under Statements on Standards for Attestation Engagements, *Financial Forecasts and Projections*, and the 1993 AICPA *Guide for Prospective Financial Information*. The

auditors report on an *examination* of forward-looking statements can be issued to the public. The auditor should emphasize to the company, however, that any agreed-upon procedures report would be limited to client officials and the board of directors and that the company and others cannot refer to the report in public statements. If underwriters require comfort with respect to forward-looking information, the auditor should refer to SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties*, for guidance.

.12 Legal counsel has advised that auditor's reports with respect to forward-looking information are eligible for the statutory safe harbor. As long as the auditor is acting within the scope of the engagement (what the statute terms acting "on behalf of the issuer"), safe harbor protection is available for "any report issued by an outside reviewer retained by an issuer, to the extent that the report assesses a forward-looking statement made by the issuer." Thus, coverage would be available for an auditor's report on wholly prospective information (for example, a report on an issuer's projected financial results for the upcoming year) or for a report on information that is both prospective and historical, such as the MD&A (in which case the report would be protected only as it relates to the issuer's forward-looking statements). Because historical financial statements are exempt from the safe harbor, reports on those financial statements receive no safe harbor protection. (The statute does empower the SEC to issue rules extending safe harbor protection to financial statement information, but it is not clear whether the Commission will exercise this authority.) The auditor should consult with legal counsel in determining whether and to what extent a particular report meets the statutory requirements for safe harbor coverage.

.13 The SEC's previous efforts at encouraging the disclosure of forward-looking statements with safe harbor protection were not successful because of the uncertainty and perceived ineffectiveness of the previous safe harbor. The new safe harbor for forward-looking statements is intended to provide real protection to registrants and auditors that provide services in connection with such statements. As with the existing safe harbor (which remains in place), the ultimate effectiveness and extent of protection will be tested through practice and proven over time in the courts.

Effective Date of Provisions

.14 Most of the provisions of the Act, including the Safe Harbor for Forward-Looking Statements, became effective on Friday, December 22, 1995. However, the Fraud Detection and Disclosure provisions of the Act apply to annual reports for any period beginning on or after January 1, 1996, with respect to any registrant that is required to file selected quarterly financial data pursuant to SEC rules or regulations, and for any period beginning on or after January 1, 1997, with respect to any other registrant.

.15 This Practice Alert is not intended to represent a legal interpretation or description of the Act; auditors should seek advice from legal counsel for such information.

[The next page is 50,821.]



Section 16,070**Practice Alert 97-1
Members in Public Accounting Firms**

(Updated through August 15, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. This document has been prepared by the SEC Practice Section Professional Issues Task Force and is based on the experiences of the individual members of the task force and matters arising from litigation and peer reviews. It has not been approved, disapproved or otherwise acted upon by any committee of the AICPA.

Financial Statements on the Internet

.01 Generally accepted auditing standards (GAAS) provides guidance to independent auditors when clients publish documents that contain information (hereinafter "other information") in addition to audited financial statements and the independent auditor's report thereon. (See SAS No. 8, *Other Information in Documents Containing Audited Financial Statements*.) Examples of such documents include annual reports to shareholders, annual reports of not-for-profit organizations, and annual reports filed with regulatory authorities under the Securities Exchange Act of 1934.¹

.02 Recent technology has changed the traditional means of disseminating information. Today, some entities are including their annual audited financial statements and related auditor's report on the Internet. The Internet is an interactive medium, where entities portray information in components referred to as "pages," which can be connected to other pages appearing elsewhere on the "Web site" through "hyperlinks." Thus, the commingling of data from various sources is controlled by the "reader" or "browser," rather than the traditional binding of tangible documents.

.03 The users of the new technology are different from the client personnel with whom the auditor most often interacts. Today, the technological frontier (the Internet) is largely a marketing arena, but those users are not limited to the familiar marketing tools. For example, an entity might decide to include (by embedding a hyperlink) marketing information in the revenue recognition section of their summary of significant accounting policies. Also, this marketing information might be updated weekly.

.04 Auditors have recently asked questions regarding the dissemination of audit reports and the accompanying financial statements on the Internet, some of which are:

¹ SAS No. 8 is not applicable when financial statements and report appear in a registration statement filed under the Securities Act of 1933. See SAS No. 72, *Letters for Underwriters and Certain Other Requesting Parties*, as amended, and SAS No. 37, *Filings Under Federal Securities Statutes*.

- Does an independent auditor have an obligation with respect to the ever-changing other information in an electronic site that contains audited financial statements and the related auditor's report?

The Auditing Standards Board recently approved for issuance an interpretation to SAS No. 8 entitled "Other Information in Electronic Sites That Contain Audited Financial Statements," to address this question. The Interpretation advises that auditors do not have an obligation pursuant to SAS No. 8 to read or consider information included in an electronic site.

- How may a client ensure the security of information integrity when published on the Internet? Tales appear daily in the news media concerning hackers breaking into previously thought secure databases, and altering or deleting information.

The auditor may wish to discuss these concerns with the client, so that the client may review the safeguards utilized to protect the data.

- Can a client who distributes its audited financial statements and auditor's report on the Internet set it up so that a user knows when they are hyper-linking to matters outside of that document?

Yes, and at least one large organization has done so by creating distinct boundaries around its "annual report." Specifically, when users either enter or leave pages of the annual report, they are warned with a message. (Alternatively, entities might wish to clearly mark each page of the annual report information as being a part of the annual report.)

Because of the way traditional documents are typically broken into much smaller "pages" for publishing on the Internet, it can be difficult for a user to locate a complete "document." Entities may wish to provide a facility on their site that would allow easy access to all parts of a document or the ability to download or print an entire document.

Auditors may wish to discuss these matters with the client during the performance of the audit.

[The next page is 50,831.]

Section 16,080**Practice Alert 97-2
Audits of Employee Benefit Plans****(Updated April 15, 1999)****NOTICE TO READERS**

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits. This document has been prepared by the SEC Practice Section Professional Issues Task Force (PITF) and is based on the experiences of the individual members of the task force and matters arising from litigation and peer reviews. It has not been approved, disapproved, or otherwise acted upon by any committee of the AICPA.

Introduction

.01 The AICPA Peer Review Program, the AICPA Professional Ethics Division, as well as the U.S. Department of Labor (DOL), continue to note a high rate of deficiencies on audits of employee benefit plans. These deficiencies primarily resulted from the auditor's failure to comply with professional auditing standards and DOL reporting requirements. Practitioners, whose work is considered deficient by the DOL's Pension and Welfare Benefit Administration (PWBA), are referred to state licensing boards and/or to the AICPA Professional Ethics Division, and could face severe consequences, including loss of license and loss of membership in the AICPA, if found to have performed deficient employee benefit plan audits. Plan administrators could face monetary civil penalties under ERISA section 502(c)(2) if found to have filed deficient audit reports.

.02 Employee benefit plans must meet a number of specialized financial, operational and regulatory requirements, and auditors have certain responsibilities for testing compliance with certain of those requirements. This Practice Alert is intended to assist auditors of employee benefit plans by providing an overview of the governmental oversight of employee benefit plans, the relevant financial accounting and reporting standards and the common deficiencies noted on such audits. This Practice Alert also includes best practices adopted by firms performing audits of employee benefit plans and an overview of current legislative developments which, if enacted, would significantly change the way employee benefit plan audits are conducted.

Governmental Oversight of Employee Benefit Plans

.03 The Employee Retirement Income Security Act of 1974 (ERISA) was enacted to protect the interests of workers who participate in employee benefit plans and their beneficiaries. To achieve this objective, ERISA requires financial

reporting to government agencies and disclosure to participants and beneficiaries, establishes standards of conduct for plan fiduciaries, and provides for appropriate remedies, sanctions, and access to the federal courts. ERISA also provides for substantial federal government oversight in the operating and reporting practices of employee benefit plans. The ERISA reporting requirements and the plans subject to those requirements are described in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*, with conforming changes as of May 1, 1999 (the AICPA Guide). This Practice Alert addresses employee benefit plans that are subject to ERISA.

Financial Accounting and Reporting Standards

.04 FASB Statement No. 35, *Accounting and Reporting by Defined Benefit Pension Plans*, established standards of financial accounting and reporting for financial statements of defined benefit pension plans, but did not establish standards for defined contribution plans or health and welfare benefit plans. The AICPA Guide provides comprehensive guidance, including the guidance prescribed by FASB Statement No. 35, on accounting, auditing, and reporting matters for defined benefit, defined contribution and health and welfare benefit plans.

.05 Employee benefit plans that are subject to ERISA are required to report certain information annually to federal government agencies—that is, the U.S. Department of Labor (DOL), Internal Revenue Service (IRS), and Pension Benefit Guaranty Corporation (PBGC) and to provide summarized information to plan participants. For many plans, the information is reported to the IRS on Form 5500, *Annual Return/Report of Employee Benefit Plan*, which includes financial statements and certain supplemental schedules (for example, plan investments and reportable transactions). Comments or questions on this Alert should be directed to the AICPA's SEC Practice Section at (201) 938-3022.

Common Deficiencies

.06 The PWBA has established an ongoing quality review program to enhance the quality of audit work performed by independent auditors in audits of plan financial statements that are required by ERISA. The AICPA, working with the PWBA, has made a concerted effort to improve the guidance available to auditors of employee benefit plans, and has incorporated such improvements in the AICPA Guide. The DOL strongly encourages the use of the AICPA Guide in meeting the requirements contained in ERISA. A complement to the AICPA Guide, the AICPA *Employee Benefit Plans Audit Risk Alert—1999*, (the AICPA Audit Risk Alert) provides an overview of recent economic, industry, regulatory, and professional developments. Both the AICPA Guide (Product No. 0123368QB) and the AICPA Audit Risk Alert (Product No. 022201QB) can be ordered from the AICPA Order Department at (888) 777-7077 by phone, or at (800) 362-5066 by fax.

.07 The PWBA, in their review of employee benefit plan audits, has noted the following common deficiencies:

- a. *Inadequate audit program or planning documentation.* Such deficiencies included lack of a specific audit program tailored to the audit

of employee benefit plans, failure to obtain/review relevant plan documents, failure to understand the operations of the plan or current developments affecting the plan, and failure to address the area of prohibited transactions in the audit program. (Chapter 5 of the AICPA Guide provides guidance on audit planning, including the limited-scope audit exemption.)

- b. Inadequate documentation of the auditor's understanding of the plan's internal control.* Such deficiencies included either no work or significantly inadequate work with respect to obtaining a sufficient understanding of the plan's internal control. (Chapter 6 of the AICPA Guide provides guidance on internal control.)
- c. Inadequate documentation supporting the audit work performed and insufficient procedures performed.* Such deficiencies included failure to perform sufficient audit work related to participant data, benefit payments and/or plan obligations. (Chapters 9 and 10 of the AICPA Guide provide guidance in these areas.) Also, in certain instances, the auditor did not test the fair market valuations, investment transactions or authorizations for investment transactions. (Chapter 7 of the AICPA Guide provides guidance on investments.) In limited-scope engagements, the auditor did not obtain the proper certification from the bank or insurance company or the certification did not cover all of the plan assets. (Paragraphs 7.51 and 7.52 of the AICPA Guide provide guidance on limited-scope auditing procedures.) In audits of multi-employer plans, the auditor performed inadequate work relating to the contributions received from contributing employers. In certain participant-directed plans, the auditor did not agree the allocation of employee contributions to selected investment options. (Chapter 8 of the AICPA Guide provides guidance on contributions received and related receivables.)
- d. Deficiencies in the auditor's report.* Such deficiencies included failure to reflect a departure from generally accepted accounting principles, and failure to report on all the years presented. (Chapter 13 of the AICPA Guide provides guidance on, and examples of, auditor's reports.)
- e. Deficiencies in the note disclosures.* Such deficiencies included failure to disclose: the investments that represent 5 percent or more of the plan's net assets available for benefits (see paragraphs 2.26g, 3.28g and 4.57 of the AICPA Guide); information as to whether or not the plan has received a favorable tax determination ruling from the IRS (see paragraphs 2.26f, 3.28f and 4.57 of the AICPA Guide); the priorities of distribution of plan assets upon termination of the plan (see paragraphs 2.26c, 3.28c and 4.57 of the AICPA Guide); the funding policy of the plan (see paragraphs 2.26d, 3.28d and 4.57 of the AICPA Guide); information regarding the method and significant assumptions used to determine the actuarial present value of the plan's accumulated plan benefits as required by FASB Statement No. 35 (see paragraphs 2.20–2.24 of the AICPA Guide).
- f. Failure to comply with ERISA's or DOL's reporting and disclosure requirements.* The most common reporting and disclosure deficiencies were as follows: the auditor's report failed to extend to one or more of the required supplemental schedules (see paragraphs 13.09–13.18

of the AICPA Guide); the required supplemental schedules failed to include all the necessary information pursuant to ERISA and DOL regulations (see Appendix paragraphs A.51(b) and A.70–A.76 and Exhibit A-1 of the AICPA Guide); the plan administrator inappropriately invoked the limited-scope audit exemption when the financial institution holding the plan's assets did not qualify for such exemption because it was not a bank or similar institution or an insurance company (see Appendix paragraphs A.57–A.58 of the AICPA Guide); the statement of net assets was not presented in comparative form as required by DOL regulations (see Appendix paragraph A.51(a) of the AICPA Guide); the notes to the plan's financial statements failed to include certain information required by DOL regulations (for example, a note reconciling financial statement amounts to amounts reported in Form 5500 Series Annual Report) (see Appendix paragraph A.51(c) of the AICPA Guide); the audit was of the trust rather than of the plan (see Appendix paragraph A.55 of the AICPA Guide).

Best Practices

.08 To assist practitioners and CPA firms improve audit quality related to audits of employee benefit plans, and to reduce related enforcement and litigation risks, best practices used by firms in performing audits of employee benefit plans are noted below. These best practices were adapted from an article titled, "A Warning to CPAs on Employee Benefit Audits," by David M. Walker, CPA, in the June 1996 edition of the *Journal of Accountancy* (reprints may be obtained from the AICPA library at (888) 777-7077; available for AICPA members only). The best practices are as follows:

- Assign professionals trained in auditing employee benefit plans—preferably at the manager and/or senior level—to employee benefit plan audits, especially for higher-risk engagements. Factors that could be indicative of a high risk employee benefit plan audit include, among other things: plan sponsor financial difficulties; significant underfunding; volatile or non-readily marketable investments (for example, real estate and derivatives); plan amendments; changes in actuarial estimates or methods; plan merger, consolidation or termination; settlement of obligations or curtailment of accrual of benefits; initial audits; existence of prohibited transactions or unusual party-in-interest transactions; weak control environment (little or no direct plan sponsor involvement with plan administration); change in trustee, custodian or record keeper; report in accordance with Statement on Auditing Standards (SAS) No. 70, *Service Organizations*, not available from trustee, custodian or third-party administrator; recent IRS or DOL investigation; and accounting changes.
- Perform second (concurring) partner reviews on higher-risk engagements (see above for factors that could be indicative of a high risk employee benefit plan audit). (Concurring partner reviews are required for members firms of the AICPA SEC Practice Section who audit plans that file Form 11-K.)
- Coordinate responsibility for employee benefit plan audits between audit and tax staff, so that qualified tax staff review the plan's tax status, transactions with parties-in-interest, and Form 5500.

- Ensure that engagement personnel have access to current guidance (see “Common Deficiencies” section above for a discussion of the AICPA Guide and the AICPA Audit Risk Alert). Ensure that engagement personnel have adequate training in employee benefit plan audits and any other related matters. (The AICPA sponsors an annual national conference on employee benefit plans, which provides hands-on interactive workshops in auditing, taxation, Form 5500 preparation, plan administration, and multi-employer plans; question and answer sessions with industry experts and government officials directly responsible for regulating employee benefit plans; and updates on all the recent and proposed employee benefit plan legislative and regulatory matters. The AICPA also offers the following self-study courses: Employee Benefit Plans I: Accounting Principles, Audits of Employee Benefit Plans, and Audits of 401(k) Plans. To obtain further information about the conference and the self-study courses, call (888) 777-7077.
- Use standardized engagement tools and documentation approaches. The AICPA has published checklists for defined benefit, defined contribution and health and welfare plans. The checklists include both industry specific and general disclosure requirements, and can be ordered from the AICPA Order Department at (888) 777-7077.
- Use the AICPA’s publication, *Financial Statement Reporting and Disclosure Practice for Employee Benefit Plans* (Product No. 008725), which gives examples on required disclosure for employee benefit plan financial statements.
- Ensure that the CPA firm’s internal inspection or monitoring program addresses employee benefit plan audit engagements and that engagement reviews are performed by qualified personnel.
- Use technical hotlines and support services provided by the AICPA and various state societies. The AICPA’s Technical Information Division offers a hotline for accounting and auditing practice questions, and can be reached, free of charge to AICPA members, at (888) 777-7077. The AICPA’s Tax Information Phone Service (“TIPS”) offers a hotline for federal, state and local tax questions, and can be reached at (888) 777-7077, option 3, or members can submit questions through the AICPA Web site (see <http://www.aicpa.org/feedback/index.htm>). TIPS charges a fee of \$3 per minute (with a \$30 minimum) from January 15 to April 15 and \$2 per minute (with no minimum) the rest of the year, whether the query is by phone or through the Web site. The fee is billed to the member’s MasterCard, Visa or Discover credit card. Also, the PWBA encourages auditors and plan filers to call its Division of Accounting Services at (202) 219-8794 with ERISA-related accounting and auditing questions and questions regarding preparation of Form 5500. Questions concerning filing requirements should be directed to the PWBA’s Division of Reporting Compliance at (202) 219-8770.
- Consider engaging the services of another CPA firm, experienced in employee benefit plan accounting, audit and ERISA matters, when necessary and appropriate.

Implementing these best practices can significantly improve audit quality and client service and reduce related enforcement and litigation risks.

Recent Developments

.09 In June 1998, the Financial Accounting Standards Board issued Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*. FASB No. 133 applies to employee benefit plans, although most plans do not hold such instruments. The AICPA's publication, *Employee Benefit Plans—1999 Audit Risk Alert*, describes the accounting effects of FASB No. 133 relating to employee benefit plans.

.10 There are currently two proposed Statements of Positions (SOPs) relating to employee benefit plans. The two SOPs would amend the Audit and Accounting Guide *Audits of Employee Benefit Plans*, SOP 92-6, *Accounting and Reporting by Health and Welfare Benefit Plans* [section 10,530], and SOP 94-4, *Reporting of Investment Contracts Held by Health and Welfare Benefit Plans and Defined-Contribution Plans* [section 10,620].

Service Organizations

.11 Many plans are now offering their participants on-line access to their 401(k) plans. In such circumstances, participants can review their accounts, and change their investment elections at any time, even from home. Because plan participants can change their investments daily, by telephone or via Intranet sites, daily valuations of such plans are becoming commonplace with virtually no record of the changes being maintained by the service provider of the plan. Additionally, more and more services are being "bundled" and provided by one service provider. These service providers execute transactions and maintain accountability on behalf of the plan administrator. For example, outside service organizations such as, bank trust departments, insurance companies, and benefits administrators may maintain records and process benefit payments. Often, the plan sponsor does not maintain independent accounting records of transactions executed by the service provider. In fact, many plan sponsors no longer maintain records such as participant enrollment forms detailing the contribution percentage and the allocation by fund option, and this amount can be changed by telephone or on-line without any record. In these situations, the auditor may be unable to obtain a sufficient understanding of internal controls relevant to transactions executed by the service organization in planning the audit and determining the nature, timing and extent of testing to be performed without considering those components maintained by the service organization. These circumstances require an understanding of the requirements of SAS No. 70, *Service Organizations*, and additional explanation is described in Practice Alert 99-2, *How the Use of a Service Organization Affects Internal Control Considerations* [section 16,140].

Year 2000 Issues

.12 Generally, the Year 2000 issues are the entity's management's responsibility and not the auditor's. Management must assess and remediate the affects of the Year 2000 issue on an entity's system. Under generally accepted auditing standards, the auditor has the responsibility to plan and perform the audit to obtain reasonable assurance whether the financial statements are free of material misstatement. Thus, the auditor's responsibility relates to the detection of material misstatement of the financial statements being audited, whether caused by the Year 2000 issues or by some other cause.

.13 However, auditors should be aware of the auditing and accounting issues that arise from the Year 2000 issue, including audit planning, going-concern issues, establishing an understanding of the services to be provided to the client, impairment of revenue and expense recognition, and disclosure. A more comprehensive discussion of this topic can be found in AICPA's *1999 Audit Risk Alert*. Additional information on Year 2000 Issues can be found on the AICPA's website.

[The next page is 50,841.]



Section 16,090**Practice Alert 97-3
Changes in Auditors and Related Topics**

**November, 1997
(Updated through
August 15, 1999)**

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing audit literature, the professional experience of the members of the Professional Issues Task Force ("PITF") and information provided by SECPS member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA.

Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used by practitioners with the understanding that it be read in conjunction with the professional literature and only as a means in assisting them in meeting their professional responsibilities.

Introduction

.01 The issues surrounding the acceptance of a new audit engagement have become increasingly complex partly due to misunderstandings in the accounting and legal professions and the issuance of new professional standards. These new Standards include Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, the recently issued SAS No. 84, *Communications Between Predecessor and Successor Auditors* (effective for the acceptance of engagements after March 31, 1998), which supersedes SAS No. 7 and its Interpretations, and SAS No. 85, *Management Representations* (effective for financial statement periods ending on or after June 30, 1998), which supersedes SAS No. 19 and its Interpretations. Predecessor auditors must also consider relevant issues when they are asked by a former client to reissue their reports on previously audited financial statements. Such issues include the need to decide whether to reestablish a client relationship, including consideration of the former client's intended use of the predecessor auditor's report. For example, a former client's request that a predecessor auditor reissue his or her report in connection with an initial public offering would expose the predecessor auditor to additional risk that was not present at the time the original report was issued. In such a situation, the predecessor auditor may consider the practicality of obtaining a limited indemnification letter that would protect him or her from the costly impact of frivolous litigation.

.02 The purpose of this Practice Alert is to assist practitioners by summarizing pertinent existing and newly issued professional standards in an attempt to clarify certain misunderstandings that currently exist in practice.

Required Communications Between Predecessor and Successor Auditors

.03 In assessing whether to accept a new client, one of the most valuable sources of information to a successor auditor is the client's former auditor. Inquiry of the predecessor auditor is a necessary procedure and may inform the successor auditor of potential disagreements that existed between the client and predecessor auditor with respect to accounting principles, auditing procedures, facts that impact the integrity of management, or similarly significant matters.

.04 The responsibility for initiating contact rests with the successor auditor. Prior to accepting the engagement, the successor auditor should request permission from a prospective client to make an inquiry of the predecessor auditor and request that the prospective client authorize the predecessor auditor to respond fully to such inquiries. If a prospective client refuses to permit communications between the predecessor and successor auditors, or limits the response of the predecessor auditor, the successor auditor should inquire as to the reasons and consider the implications of such a refusal in deciding whether to accept the engagement.

.05 SAS No. 84 explains that subsequent to receiving client approval, the successor auditor should make specific and reasonable inquiries of the predecessor auditor. The matters subject to inquiry include: (1) information that might bear on the integrity of management; (2) disagreements with management as to accounting principles, auditing procedures, or other similarly significant matters; (3) communications to audit committees or others with equivalent authority, regarding fraud, illegal acts by clients, and internal control related matters; and (4) the predecessor auditor's understanding as to the reasons for the change of auditors.

.06 The predecessor auditor should respond fully to the successor auditor's inquiries, but may, due to certain circumstances such as potential or pending litigation, disciplinary proceedings, or other unusual circumstances, decide it is in his or her best interests not to respond fully. In such circumstances, the predecessor auditor should inform the successor auditor that the response is limited. Such a limited response should be carefully evaluated by the successor auditor in deciding whether to accept the engagement.

Review of Working Papers

.07 After accepting the engagement, the successor auditor should request the client to authorize the predecessor auditor to allow a review of the predecessor auditor's working papers. In such situations, the predecessor auditor may want to obtain written notification of such a request in an effort to reduce or avoid misunderstandings. Appendix A to SAS No. 84 provides an illustrative client consent and acknowledgment letter which the predecessor auditor may wish to send the former client. It has long been considered customary that the predecessor auditor make available to the successor auditor certain working papers for review. Pursuant to SAS No. 84, the predecessor auditor should ordinarily permit the successor auditor to review working papers including documentation of planning, internal control, audit results and other matters of continuing accounting and auditing significance. Before permitting access to the working papers, the predecessor auditor may wish to obtain a written communication from the successor auditor regarding the use of the working papers. Appendix B to SAS No. 84 includes an illustrative successor auditor acknowledgment letter.

Opening Balances

.08 The responsibility for analyzing the impact of the opening balances on the current year financial statements and consistency of accounting principles always rests with the successor auditor. The successor auditor must obtain sufficient competent evidential matter to afford a reasonable basis for expressing an opinion on the financial statements under audit. The successor auditor must use professional judgment in determining the extent of procedures to be performed with respect to opening balances in light of the audit evidence obtained in conjunction with his or her current year audit.

.09 Audit evidence that may be obtained by a successor auditor may include the following:

1. The most recently audited financial statements and the predecessor auditor's opinion thereon. For example, the degree of comfort a successor auditor will have from an unqualified opinion issued on a prior period with a small number of significant accounting issues will typically be higher than a qualified or adverse opinion on a client with complex or significant accounting issues. Additionally, the successor auditor should also consider the professional reputation of the predecessor auditor in forming his or her opinion on the opening balances. For example, a firm with a sound reputation in the business community and an unqualified opinion on its most recent peer review may give the successor auditor comfort with respect to opening balances.
2. The results of inquiries made to predecessor auditors. For example, a successor auditor would normally have a greater degree of comfort based on responses from a predecessor auditor that there were no disagreements with respect to the application of accounting principles or auditing procedures. Also, a successor auditor should consider the impact on opening balances when the predecessor auditor informs the successor auditor that his or her response to questions and access to certain working papers was limited.
3. The results of the successor auditor's review of the predecessor auditor's working papers may affect the nature, timing, and extent of the successor auditor's procedures. For example, upon reviewing a predecessor auditor's working papers with respect to contingencies at the beginning of the year, the successor auditor may conclude that the predecessor auditor's assessment of internal controls, substantive testing, and evaluation of misstatements is sufficient to preclude applying procedures to prior year transactions, and may take comfort from a current year attorney's letter or other procedures.
4. The results of audit procedures performed in the current year's audit that provide evidence about opening balances or consistency of application of accounting principles. For example, current year collections of accounts receivable may give an auditor comfort with respect to the validity of accounts receivable recorded at the end of the prior period.

In those rare circumstances where a successor auditor is not allowed access to a predecessor auditor's working papers, the successor auditor should consider the implications on whether the successor auditor will be able to obtain sufficient competent evidential matter to afford a reasonable basis for expressing

an opinion on the financial statements under audit. A successor auditor should not necessarily interpret a refusal for access to a predecessor auditor's working papers as a need to perform an audit of the previously audited financial statements. In such circumstances, the successor auditor should use professional judgment in determining the nature, timing, and extent of procedures to be performed on opening balances. Such procedures, as outlined in 1, 2 and 4 above, will assist the successor auditor in determining the need to perform an audit of the previously audited financial statements.

Requests to Reissue Reports

.10 Predecessor auditors may be asked to reissue their report on financial statements for a number of reasons, including requests made by a former client to include a predecessor auditor's report in a registration statement filed with the SEC. In such situations, the predecessor auditor is, in effect, being asked to reestablish a client relationship and should consider the ramifications of that decision.

.11 Before consenting to the inclusion of his or her report on previously audited financial statements, a predecessor auditor should perform procedures similar to its client acceptance and continuation procedures as required by Statement on Quality Control Standards (SQCS) No. 2, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, paragraphs 14 through 16. In determining the nature and extent of client acceptance and continuation procedures as required by SQCS No. 2, an auditor might consider the recommendations of the AICPA Joint Task Force on Quality Control Standards, in its Guide titled, *Guide for Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice* (Product No. 067020, which can be ordered from the AICPA Order Department at (888) 777-7077).

.12 Such procedures would typically include an evaluation of whether specific events have occurred to determine whether a relationship with the former client should be reestablished, including a major change in one or more of the following: (1) management; (2) directors; (3) ownership; (4) legal counsel; (5) financial condition; (6) litigation status; (7) nature of the company's business; and (8) the scope of the engagement. Additionally, an auditor should determine whether he or she should be associated with a client that has selected, or may select, an underwriter that has been the subject of adverse publicity or that has matters reported on the underwriter's Form BD that raise questions or concerns about the underwriter. Similarly, an auditor should consider the professional reputation and experience of both the successor auditor and legal counsel who is or will be associated with subsequent years' financial statements.

.13 After consideration of the above, and other relevant factors, but before consenting to reissuance of his or her report, the predecessor auditor should consider whether that report is still appropriate in the circumstances. The auditor should perform procedures on events occurring subsequent to the date or period of the most recent financial statements. The nature and extent of the procedures will vary depending on the circumstances of the particular situation, but generally consist of the following (as per SAS No. 58, *Reports on Audited Financial Statements*, as amended):

.14 If a successor auditor has audited the financial statements of the most recent period following the period audited by the predecessor auditor, subsequent events procedures may consist of the following:

- Reading the financial statements for the current period (or the entire registration statement if the financial statements are included in a filing with the SEC).
- Comparing the financial statements that were reported on by the predecessor auditor with the financial statements to be presented in the registration statement (or other document).
- Obtaining a letter from the successor auditor indicating whether their audit has disclosed any events or transactions subsequent to the period covered by the most recent statement of income (or the date of the latest balance sheet) audited by the predecessor auditor that, in the successor auditor's opinion, would have a material effect on, or require disclosure in the financial statements reported on by the predecessor auditor.

.15 SAS No. 85 adds the additional requirement that a predecessor auditor obtain a representation letter from management of the former client in conjunction with reissuing his or her report on previously audited financial statements. This representation letter from management should state that nothing came to management's attention that would cause them to believe that any of their previous representations should be modified and 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. Appendix C to SAS No. 85 includes an illustrative management representation letter that might be obtained in these circumstances. In addition to the above described procedures, an auditor should consider the relevant guidance in SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*, as amended, paragraphs 10 through 12, which provides suggested procedures that may be performed when additional evidential matter might be necessary in the circumstances.

.16 If, after performing the procedures enumerated above and other procedures considered necessary in the circumstances, a predecessor auditor becomes aware of events or transactions occurring subsequent to the date of his or her previous report that may require an adjustment, additional disclosure, or reclassification to the financial statements previously reported on, the predecessor auditor should make inquiries and perform other procedures that are considered necessary in the circumstances.

.17 The extent of such procedures is a matter of professional judgment and will vary depending on the effect of the items on the financial statements previously issued. For example, reviewing the reclassification of a line of business as discontinued operations for comparative purposes with the subsequent year's treatment, resulting from a subsequent decision made by the company, would generally require less extensive procedures than those that may be required in connection with the correction of an error in previously issued financial statements. In such instances, the predecessor auditor might consider requesting a review of the working papers of the successor auditor in those areas related to the matter affecting the prior-period financial statements. Based on the evidence obtained, the predecessor auditor should then decide whether to revise the previously issued report. When reissuing his or her report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report; if the financial statements are restated or the predecessor auditor revises the previous report, the report should be dual dated.

.18 If successor auditors have not been engaged, or if engaged, have not performed an audit of the subsequent financial statements or sufficiently familiarized themselves with the accounting policies, control environment and other pertinent aspects of the company, the predecessor auditor's subsequent events review procedures might be the same as those performed by a continuing auditor in accordance with SAS No. 1, section 560, *Subsequent Events*, as amended.

.19 After considering the above or other relevant factors, an auditor may decide not to consent to the use of his or her previously issued report. The AICPA's Code of Professional Conduct (SAS No. 58, *Reports on Audited Financial Statements*, as amended, paragraph 70), and the rules and regulations of the SEC do not require an independent certified public accountant who has performed a financial statement audit, to subsequently sign a consent for inclusion of that report in a registration statement filed with the SEC, or for any other reason. Additionally, SAS No. 58, *Reports on Audited Financial Statements*, as amended, does not require the predecessor auditor to communicate or disclose the reasons why that auditor decided not to reissue his or her audit report and there is no requirement for disclosure of those reasons to the entity or its audit committee, as a client relationship does not exist.

Audits of Financial Statements Previously Audited

.20 If a predecessor auditor declines to reissue his or her report on previously issued financial statements, a former client may decide to engage the successor auditor to audit the financial statements previously reported on (hereafter referred to as a "reaudit") by the predecessor auditor. In such cases, the successor auditor should perform the procedures required of successor auditors as outlined in the section above, "Required Communications between Predecessor and Successor Auditors." In a reaudit, the successor auditor generally will be unable to observe inventory or make physical counts at the reaudit date or dates in the manner described in paragraphs 9 through 11 of SAS No. 1, section 331, *Inventories*, as amended.

.21 In such cases, the successor auditor may consider the knowledge obtained from his or her review of the predecessor auditor's working papers and inquiries of the predecessor auditor to determine the nature, timing and extent of procedures to be applied in the circumstances. However, the information obtained from those inquiries and review of the predecessor auditor's working papers are not sufficient to afford a basis for expressing an audit opinion.

.22 If material, the successor auditor performing the reaudit should make, or observe, some physical counts of inventory at a date subsequent to the period of the reaudit, whether in connection with a current audit, or otherwise, and apply appropriate tests of intervening transactions.

Use of Indemnification Clauses When Reissuing Reports

.23 In many instances, the risk of litigation that results from the inclusion of a predecessor auditor's report on financial statements of a former client may be such that a predecessor auditor might decide not to reissue his or her report unless the former client agrees to indemnify them for legal and other costs that might be incurred in defending itself, in the event of threatened or actual litigation, for its association with the financial statements of the former client. In general, AICPA Ethics Ruling 94 allows obtaining such indemnification agreements. However, SEC rules related to independence prohibit indemnification agreements between auditors and current publicly-held clients.

.24 As a result of discussions between the AICPA and the SEC, the staff of the SEC agreed not to question a predecessor auditor's independence with respect to a former audit client if that former audit client agrees to indemnify the predecessor auditor for the payment of legal costs and expenses that the predecessor auditor might incur in defending itself against legal actions or proceedings that arise as a result of the consent of that predecessor auditor to the inclusion of its auditor's reports on the former audit client's prior year's financial statements in a new registration statement provided that: (1) Such indemnification letter would be void and any advanced funds would be returned to the former client if a court, after adjudication, found the former auditor liable for malpractice, and (2) The indemnification provision is entered into after a successor auditor has issued an audit report on the former client's most recent financial statements included in the registration statement of the former client.

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Section 16,100

Practice Alert 98-1 **The Auditor's Use of Analytical Procedures**

(Updated through August 15, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing audit literature, the professional experience of the members of the Professional Issues Task Force (PITF) and information provided by SECPS member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used by practitioners with the understanding that it be read in conjunction with the professional literature and only as a means of assisting them in meeting their professional responsibilities.

Introduction

.01 Analytical procedures are defined by Statement on Auditing Standards (SAS) No. 56, *Analytical Procedures*, as "evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data." Analytical procedures are used in all three main phases of an audit: planning, substantive testing and overall review. The use of analytical procedures in the planning and overall review phases of an audit is required under generally accepted auditing standards and plays an important role in assisting the auditor in determining the nature, timing and extent of his or her substantive testing and in forming an overall opinion as to the reasonableness of recorded account balances.

.02 The use of analytical procedures in the substantive testing phase of the audit is a consideration left to the judgment of the auditor and may or may not be a preferred choice to traditional detail tests of transactions. However, the use of analytical procedures typically enables the auditor to perform substantive tests that provide sound audit evidence, assists the auditor in better understanding a client's business, and when performed properly, may result in a more efficient and effective means of testing an account balance.

.03 This Practice Alert provides guidance to practitioners on:

- Applying substantive analytical procedures through discussion of certain key concepts and definitions related to forming expectations of recorded balances,
- Difficulties noted in the performance of analytical procedures, and
- How analytical procedures can assist the auditor in evaluating the risk of fraud.

Substantive Analytical Procedures—Key Concepts and Discussion

.04 Developing analytical procedures is a four-step process that consists of: (1) the development of an expectation; (2) the identification of fluctuations; (3) the investigation of material fluctuations and (4) the evaluation of the likelihood of material misstatements being present in the financial statements.

.05 The following discussion focuses on definitions and concepts pertinent to an auditor's development of an expectation and how accurate that expectation should be based on the risk characteristics of a particular engagement and should be read in conjunction with SAS No. 56 and the AICPA Publication *Analytical Procedures—Auditing Practice Release* (the "APR").

Expectations

.06 Expectations are the auditor's prediction of what a recorded account balance or ratio *should* be. Auditors may be less likely to detect significant unexpected differences in the financial statements of a client when an expectation has not been properly developed. In forming an expectation, the auditor must determine that the relationship between the items used to develop the expectation and the recorded amount is plausible because the items might sometimes appear to be related when they are not, leading to erroneous conclusions. Plausible relationships are best defined as relationships expected to exist based on the auditor's understanding of the client and the industry in which the client operates.

.07 To gain this understanding the auditor might analyze forces external to the client's industry, the client's position within the industry and the processes the client has in place to achieve its objectives. The auditor might also consider the results of prior years audits, the client's budgeted and actual amounts, discussions held with client personnel responsible for the preparation of recorded account balances or ratios and financial and nonfinancial results of comparable entities operating in the industry.

.08 An expectation is typically developed using one or more of the following types of internally prepared data: prior year data adjusted for expected change; current period data; budgets or forecasts; and nonfinancial data from within the entity. These types of data might be considered independent and reliable if they are consistent with current business conditions and not subject to influence or manipulation by persons involved in the accounting functions related to the account balance being tested.

.09 Often, the account balance being tested can be estimated using data external to the entity. Sources of external information might include: government agencies (e.g., changes in tax rates); industry regulators, trade associations, industry surveys (e.g., bank interest rates); published financial information for companies of a similar size and/or with similar characteristics in the same industry; and securities exchanges.

.10 The auditor should consider the following factors which may limit or preclude the use of external information: industry statistics may be biased by the results of one or two major players within the industry; the client's activities may not match those that are covered by the information; industry statistics may only reflect prior year history; and the quality of industry statistics depends upon the degree of care taken by the industry participants in completing periodic returns.

.11 In assessing the relationship between data used and the account balance being tested, the auditor should give consideration to the following factors: data may exist for only a part of the account balance being tested (e.g., comparable industry data is only available for certain of the products sold by the company); the relationship is circular or deterministic (e.g., predicting sales balances from commissions when commissions are calculated as a percentage of sales); the effects of changes in relationships, seasonality and lags (e.g., the client may have discontinued a product line, sales are in peak seasons, or the item of audit interest may be related to data of a prior period, such as the collectibility of receivables may be based on sales that occurred in prior periods).

.12 The auditor should also bear in mind that relationships in income statement account balances tend to be more predictable than relationships involving only balance sheet accounts. Income statement account balances generally represent accumulations of similar transactions processed over a period of time and often have a predictable relationship with other data. Balance sheet items are the residual balance from transactions at specific points in time and are often more subject to management discretion.

.13 The level of disaggregation and reliability of the data used in forming an expectation determines, in part, the precision with which the auditor can estimate an account balance. The desired precision of the expectation can vary according to the purpose of the analytical procedure. For example, an auditor would typically want more precision in performing substantive-type analytical procedures than in performing preliminary analytical procedures during planning. Generally, the higher the level of disaggregation of the data, the more precise the expectation will be. The reliability of the data is influenced by whether the data is:

- Audited
- From independent sources outside the entity
- From sources within the entity that are independent from those responsible for the amount being tested
- Subject to a reliable system of internal controls

Research has shown that incorrect expectations have been formed by the use of unreliable data and have led to incorrect audit conclusions. The auditor should exercise professional skepticism in considering the reliability of data used in forming expectations.

.14 *Precision*—Precision is a measure of the closeness of the auditor's expectation to the actual amount (which may or may not be the recorded amount). Factors that affect the level of precision of an expectation include the basis upon which the expectation is developed (such as trend analysis, ratio analysis, reasonableness testing or regression analysis), the level of disaggregation of the data, the reliability of the data and the nature of the account balance being tested (e.g., income statement accounts might be less difficult to develop expectations for than balance sheet accounts).

.15 *Trend analysis*—Trend analysis is the analysis of change(s) in an account balance over time and is most appropriate when the account or relationship is fairly stable. Conversely, trend analysis is less effective in situations when the entity being audited has experienced significant operating or accounting changes. Trend analysis typically produces the most effective results and higher levels of assurance when performed on disaggregated data, because at an aggregate level it tends to be relatively imprecise.

.16 When using this type of analytical procedure, an auditor needs to gain a sufficient understanding of the environment and its associated volatility as it relates to the account being tested. Because trend analysis does not take into account changes in the business environment in which an entity operates, it is often suited for account balances where lower levels of assurance are necessary to reduce detection risk to acceptable levels. Trend analysis is often most useful to the auditor when used in conjunction with the planning and overall review stages of the audit. Refer to the upcoming APS for case study examples on the effective use of trend analysis.

.17 *Ratio Analysis*—Ratio analysis is the comparison of relationships between financial statement accounts (between two periods or over time), the comparison of an account to nonfinancial data, or the comparison of relationships between entities operating within an industry. Ratio analysis may be considered most appropriate when the relationship between accounts is fairly predictable and stable.

.18 Ratio analysis, like trend analysis, typically produces the most effective results and higher levels of assurance when performed on disaggregated data, because at an aggregate level it tends to be relatively imprecise. Refer to the APR for case study examples on the effective use of ratio analysis.

.19 *Reasonableness testing*—Reasonableness testing is the analysis of account balances or changes in account balances within an accounting period which involves the development of an expectation based on financial and/or nonfinancial data. Reasonableness tests rely on the auditor's knowledge of the entity and the environment in which it operates to develop expectations of an account balance. As an example of a reasonableness test, an auditor might consider using the number of employees hired and terminated, the timing of pay changes, and the effect of vacation and sick days to develop a model that could predict the change in payroll expense from the previous year to the current balance. Refer to the upcoming APS for case study examples on the effective use of reasonableness testing.

.20 *Regression analysis*—Regression analysis involves the use of statistical models to quantify the auditor's expectation(s) with measurable risk and precision levels. Regression analysis bears a resemblance to reasonableness testing in that it involves using the auditor's knowledge of the factors that affect the account balance in developing a model to predict it. Because regression analysis often involves the use of internally prepared data, it is most effective in assisting the auditor in detecting material misstatements in account balances when the data is disaggregated and is from an accounting system with good internal controls.

.21 For analytical procedures used as substantive tests, the precision of the expectation developed is the primary determinant of how much assurance the auditor may obtain from such tests. In other words, the more assurance an auditor needs to obtain from analytical procedures on account balances where the risk of misstatement is high, the more precise his or her expectation needs to be. Because it involves the development of an expectation based on relatively sophisticated models, regression analysis generally tends to give the auditor more precision than any of the previously mentioned methods. Refer to the upcoming APS for case study examples on the effective use of regression analysis.

Level of Assurance

.22 The level of assurance that must be obtained in any audit testing is the amount of assurance the auditor needs to reduce detection risk to an

acceptable level. The level of assurance an auditor actually receives from a substantive analytical procedure is the degree to which the analytical procedure actually reduces audit risk. As such, an auditor plans the level of assurance he or she wishes to achieve in performing analytical procedures based on risk assessment in the planning stages of the audit. As the level of assurance needed from an analytical procedure increases, the auditor should design the analytical procedure with a corresponding level of precision.

.23 *Confirmation of Accounts Receivable and the Use of Analytical Procedures*—In certain circumstances, auditors have concluded that it may be more effective to use analytical procedures as an alternative to confirmations when testing accounts receivable. Auditing standards presume that confirmation procedures are generally performed in conjunction with testing of accounts receivable.

.24 The decision to utilize alternative procedures may be reached only after the auditor has carefully concluded that one of the following three conditions are present (SAS No. 67, *The Confirmation Process*, paragraphs 34 and 35): (1) accounts receivable are immaterial to the financial statements; (2) the use of confirmations would be ineffective; or (3) the assessed level of inherent and control risk is low, and the assessed level, in conjunction with the evidence expected to be provided by analytical procedures or other substantive tests of details, is sufficient to reduce audit risk to an acceptably low level. The auditor's conclusions should be documented in the working papers.

.25 In the event that confirmations are not used when testing accounts receivable balances and the auditor decides to use analytical procedures as substantive tests, the analytical procedures should be designed with a high level of precision in order to gain a tolerable level of assurance.

Difficulties in Applying Substantive Analytical Procedures and Ways to Avoid Them

.26 While analytical procedures can potentially improve audit efficiency and effectiveness, they also require the use of significant audit judgment in identifying and investigating unexpected fluctuations. Some of the difficulties posed and ways to address them were discussed in an article that appeared in the Nov. 1997 *Journal of Accountancy* entitled "When Judgment Counts" (reprints may be obtained from the AICPA library at (888) 777-7077; available for AICPA members only). These issues are generally discussed below.

.27 *Using Unaudited Balances as a Starting Point*—Auditors should be careful not to use management's unaudited balance as a starting point in determining what a recorded balance should be without also looking to other predicative factors. For example, assume an auditor forms an expectation of what a recorded cost of sales balance should be based on a client's unaudited sales balance. In developing an expectation for what sales should be, the auditor used a trend analysis. It is unlikely that either result in this example has actually been audited in that the auditor has not developed an expectation on an independent basis using sufficiently reliable data. SAS No. 56 includes specific wording that instructs the auditor of his or her responsibility to develop an independent expectation using reliable data.

.28 While auditors should be careful not to let unaudited account balances unduly influence their development of expectations of an account balance they

should also be aware that unaudited information, independent of the accounting function, may provide reliable information to assist in developing an expectation.

.29 *Unusual Fluctuations Might Reflect a Pattern*—SAS No. 56 indicates that an auditor should evaluate significant differences between an expectation that he or she has developed and the amount recorded in the financial statements. In addition, an auditor should take care to recognize a pattern of fluctuations which may be necessary to correctly identify the cause of a fluctuation. Tendencies to examine each account without regard to combinations of financial discrepancies may result in problematic situations being overlooked.

.30 As an example, assume an auditor has developed an expectation related to sales that is significantly lower than the actual recorded balance. In addition, the results of positive confirmations in accounts receivable indicated a number of discrepancies. These two problems, in combination, might indicate to the auditor that the sales balance and related receivables balance are misstated. Should the auditor consider the discrepancies noted in each balance in isolation, there might be a tendency to “explain” each discrepancy away without seeing a potentially serious issue.

.31 *Placing Reliance on Management’s Explanations*—Auditors should use discretion in using management as a first resource in explaining unexpected fluctuations as a client’s explanation might limit the auditor’s consideration of other likely causes. An explanation that is offered by management in situations where the auditor cannot readily explain the variance between his or her expectation and the recorded amount should be carefully evaluated as to both its reasonableness in explaining the variance noted and its effect(s) on other accounts.

.32 Information which may provide plausible explanations for fluctuations that should be considered by the auditor might include: an understanding of matters noted while performing audit work in other areas, particularly while performing audit work on the data used to develop an expectation; inquiries of client personnel unrelated to the preparation of the financial statements, analytical procedures performed in the planning stage of the audit; management and board reports containing explanations of variances between budgeted and actual results; and review of minutes of meetings.

.33 *Developing Expectations at the Appropriate Level of Disaggregation*—In addition to the issues identified in the *Journal of Accountancy* article, auditors should be careful while performing substantive analytical procedures to use data at an appropriate level of disaggregation. Use of data that is disaggregated at the appropriate level is important in allowing the auditor to assess the risk of material misstatement in the financial statements.

.34 For example, an auditor would have more information on which to base a conclusion on sales balances if that amount were considered on a monthly or quarterly basis than on an annualized basis. Generally, the more complex and non-routinely processed the amount to be tested is, the more difficult it is to develop an expectation that is sufficiently precise to provide adequate assurance that material misstatement does not exist.

.35 By not analyzing data at the appropriate level of disaggregation, an auditor may not be as likely to detect unusual fluctuations caused by significant non-routine journal entries in the final quarter of a client’s fiscal year.

Unusual non-routine journal entries, if recorded consistently by the client over a period of years, would not necessarily be detected by the auditor when analyzing data on an aggregate level. Such fourth quarter adjustments might alert the auditor to an audit area requiring additional testing or even be indicative of the possibility of fraud.

Analytical Procedures and Fraud Detection

.36 The results of analytical procedures do not provide the auditor with the necessary evidence to determine if fraud has resulted in a material misstatement to the financial statements. However, analytical procedures, performed during the planning, substantive testing and overall review stages of the audit, do provide the auditor with a tool in determining if account balances might have an increased chance of having been subjected to fraud. Accordingly, analytical procedures can assist the auditor in fulfilling his or her responsibilities under paragraph 12 of SAS No. 82, *Fraud in a Financial Statement Audit*, which states, in part, that "The auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and should consider that assessment in designing the audit procedures to be performed."

.37 SAS No. 82 requires that an auditor should specifically assess the risk of material misstatement of the financial statements due to fraud and consider that assessment in designing his or her audit procedures. Analytical procedures have the potential to detect the possible existence of fraud during the planning stage by directing the auditor's attention to unexpected fluctuations or relationships. By performing such procedures at the appropriate level of disaggregation, the auditor has the potential to detect where such fraud might be present.

.38 Even in situations where the auditor expects the client to adjust its trial balance after the completion of preliminary analytical procedures, he or she should consider whether some accounts, such as debt, might be less likely to be adjusted than others, such as expense accounts. In these situations, the auditor would still be able to analyze certain accounts in the planning stages and assess the likelihood that a material misstatement might exist.

.39 SAS No. 82 indicates that if certain risk factors are present that would indicate the likelihood of fraud, the auditor might respond by performing substantive analytical procedures at a more detailed level.

[The next page is 50,871.]



Section 16,110

Practice Alert 98-2 ***Professional Skepticism and Related Topics***

(Updated through August 15, 1999)

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing audit literature, the professional experience of the members of the Professional Issues Task Force (PITF) and information provided by SECPS member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein if used by practitioners should be used with the understanding that it is read in conjunction with the professional literature and only as a means of assisting them in meeting their professional responsibilities.

Introduction

.01 Generally accepted auditing standards requires the auditor to exercise due professional care in the planning and performance of the audit and in the preparation of the auditor's report. Due professional care requires the auditor to exercise professional skepticism, which can be best defined as an attitude that includes a questioning mind and working practices that encompass a critical assessment of audit evidence. Since evidence is gathered and evaluated throughout the audit, professional skepticism should be exercised throughout the entire audit process. In gathering and evaluating evidence, including obtaining management representations, the auditor should neither assume that management is dishonest nor assume unquestioned honesty. Exercising professional skepticism means that the auditor should not be satisfied with less than persuasive evidence. Although representations obtained from management are part of the evidential matter the independent auditor obtains, they are rarely by themselves sufficient evidence to afford a reasonable basis for an opinion regarding the financial statements taken as a whole.

.02 There have been a number of instances in the past when misstated audited financial statements have been issued when the auditor may not have exercised adequate professional skepticism during the audit. While it is not possible to list all sensitive areas where this might occur, experience suggests that the following areas should be among those subject to particular scrutiny:

- Management responses to questions resulting from analytical reviews.
- Representations regarding recoverability of assets or deferred charges.

- Accruals (or lack thereof), particularly for unusual events or transactions.
- Substance of large and unusual (particularly period-end) transactions.
- Vague contract terms or conditions.
- Non-standard journal entries and copies of original documents (see further discussion below).

.03 Regular reminders to members of the firm and professional staff of the need to exercise appropriate professional skepticism would be useful in avoiding potential problems. This Practice Alert provides guidance to practitioners in two areas which may warrant a relatively high level of professional skepticism and attention to audit evidence: (1) the review of non-standard journal entries, and (2) the review of original and final versions of source documents rather than photocopies or draft versions in these two areas. This Practice Alert also provides a comprehensive list of previously issued Practice Alerts.

The Auditor's Review of Non-Standard Journal Entries

.04 Statement on Auditing Standards (SAS) No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* requires the auditor to obtain a sufficient understanding of the information system relevant to financial reporting to understand:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- How those transactions are initiated (e.g., manual or computerized).
- The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of transactions.
- The accounting processing involved from the initiation of a transaction to its inclusion in the financial statements, including electronic means used to transmit, process, maintain and access information.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

SAS No. 78 also notes that such knowledge should be used to identify types of potential misstatements, consider factors that affect the risk of material misstatement, and design substantive tests.

.05 In today's complex computerized environments, reviewing the general ledger for non-standard journal entries has changed significantly from years ago when the general ledger could be manually scanned for evidence of non-standard journal entries. Standard journal entries include those journal entries processed in the normal course of business, such as sales, inventory purchases and cash disbursements. Non-standard journal entries are ones that are made outside the normal course of business, such as the provision for loan losses, provision for inventory obsolescence and cut-off or period-end adjustments. Non-standard journal entries may pose increased risk to the auditor in

that they might conceal attempts by management to manipulate earnings and can be recorded in practically any account.

.06 Auditors may find that certain accounts might contain transactions processed in the normal course of business and some that are not. As an example, consider accounts payable, which may contain routine postings from the accounts payable subsidiary ledger to the general ledger, but may also contain entries to reconcile the two ledgers. The accounts payable account balance may also include debits to the account with an offset entry intended to inflate earnings. Since accounts payable is often subject to a high volume of activity, such reconciling entries or miscellaneous debits, or non-standard journal entries, may be difficult for the auditor to detect.

.07 In order to determine which transactions are not subject to processing in the normal course of business, the auditor should consider whether the client has an established routine, or set of procedures, for processing a class of transactions on a recurring basis. Often, there will be an established routine whose recording is frequently recurring and is important to the day-to-day operation and management of the business. Routine processing does not necessarily or exclusively involve computer systems. Most processing involves a combination of manual and automated steps and procedures.

.08 Transactions processed in the normal course of business generally have less risk of misstatement than other transactions. In order to identify transactions processed outside the normal course of business, particularly in computerized environments, the auditor may need to use computer-assisted audit techniques, such as report writers, software or data-extraction tools, or other systems-based techniques. The functionality of the software and proper processing with the client data files is essential to produce credible evidence. Electronic evidence often requires extraction of the desired data by a knowledgeable auditor or a specialist. SAS No. 31, *Evidential Matter*, as amended by SAS No. 80, *Amendment to Statement on Auditing Standards No. 31, Evidential Matter*, provides guidance for auditors who have been engaged to audit the financial statements of an entity that transmits, processes, maintains or accesses significant information electronically. In addition, the AICPA published an Auditing Procedures Study, *The Information Technology Age: Evidential Matter in the Electronic Environment*, to provide auditors with non-authoritative guidance on applying SAS No. 80. Account balances which might be subject to misstatement may be identified by the auditor in assessing whether each significant account balance:

- Contains journal entries processed outside the normal course of business.
- Contains transactions that are complex or unusual in nature.
- Contains estimates and period-end adjustments.
- Contains journal entries indicative of potential problems with the accounting systems.
- Has been prone to client error in the past.
- Has not been reconciled on a timely basis or contains old reconciling items.
- Represents a particular risk specific to the client's industry.
- Represents account balances affecting the client's value and liquidity (e.g., account balances that are used in determining loan covenant ratios).

The Auditor's Review of Original and Final Source Documents

.09 During the course of an audit of financial statements, auditors are frequently provided with photocopies or draft versions of documents, rather than original and final source documents. Of course, photocopies can be made of virtually every type of audit evidence, including bank statements, invoices, legal agreements, etc., and by accepting photocopies or draft versions as audit evidence, the auditor risks that the photocopy may not conform to the original and final source document. Also, with the advances in modern technology, scanners can also be used to alter documents. As an example, consider that bank statements can be altered and photocopies to reflect higher cash balances, invoices can be falsified to reflect sales which did not take place and legal agreements can be amended so that the photocopy does not reflect the actual agreement in place.

.10 SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, states that the unavailability of other than photocopied documents when documents in original form are expected to exist may pose a risk of material misstatement due to fraud. When presented with photocopied documents, the auditor should exercise professional skepticism and consider the need to obtain the original source documents to ensure conformity to the photocopied documents.

.11 Also, when reviewing a document other than an original, there may be situations when an auditor receives a facsimile confirmation response rather than a written communication mailed directly to the auditor. A facsimile response may create some risk because it may be difficult to ascertain the source of the response. While the facsimile response may include the name and facsimile number of the entity sending the document, the auditor should assess the risk that the sender might have falsified that information. SAS No. 67, *The Confirmation Process*, states that to restrict the risk associated with facsimile responses and treat the confirmations as valid audit evidence, the auditor should consider taking certain precautions, such as verifying the source and contents of a facsimile response in a telephone call to the purported sender. In addition, the auditor should consider requesting the purported sender to mail the original confirmation directly to the auditor.

[The next page is 50,881.]

Section 16,120**Practice Alert 98-3
Revenue Recognition Issues**

November, 1998

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing audit literature, the professional experience of the members of the Professional Issues Task Force (PITF) and information provided by SECPS member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein if used by practitioners should be used with the understanding that it is read in conjunction with the professional literature and only as a means of assisting them in meeting their professional responsibilities.

Introduction

.01 A substantial portion of litigation against accounting firms reported to the AICPA SEC Practice Section Quality Control Inquiry Committee and a number of SEC Accounting and Auditing Enforcement Releases continue to involve revenue recognition issues. Many of these issues result from what appears to be improper accounting treatment of sales recorded in the ordinary course of a client's business. Such improper accounting treatment ranges from stretching the accounting rules to falsifying sales in an effort to manage earnings. Therefore, auditors need to pay attention to warning signals that may indicate increased audit risk with respect to revenue recognition and respond with appropriate professional skepticism and additional audit procedures.

.02 This Practice Alert is intended to remind auditors of certain factors or conditions that can be indicative of increased audit risk of improper, aggressive or unusual revenue recognition practices, and the Practice Alert suggests ways in which auditors may reduce the risk of failing to detect such practices. This Practice Alert also refers to professional guidance which address the accounting considerations for revenue recognition, and it reminds auditors of their responsibilities to communicate with the board of directors and audit committees.

Improper, Aggressive or Unusual Revenue Recognition Practices

.03 Auditors need to consider the possibility that client personnel at various levels may participate in schemes that result in the overstatement of revenue. In some cases, customers and suppliers may be involved in such schemes as well. Client officials may be aware they are overstating revenue or

may simply believe they are reflecting economic substance from their perspective. Revenue recognition principles are sometimes difficult to apply and often vary by industry. A high level of care is always required in this area, but if the auditor becomes aware of certain factors or conditions, as outlined below, special consideration may be required:

Control environment:

- Aggressive accounting policies or practices (“pushing the edge” on accounting policies and/or procedures).
- Pressure from senior management to increase revenues and earnings.
- Lack of involvement by the accounting/finance department in sales transactions or in the monitoring of arrangements with distributors.

Issues requiring special consideration:

- A change in the company’s revenue recognition policy.
- Sales terms do not comply with the company’s normal policies.
- Existence of longer than expected payment terms or installment receivables.
- Significant sales or volume of sales that are recorded at or near the end of the reporting period.
- Unusual volume of sales to distributors/resellers (i.e., “channel stuffing”).
- Sales are billed to customers prior to the delivery of goods and held by the seller (“bill and hold” or “ship-in-place” sales).
- The use of non-standard contracts or contract clauses.
- The use of letters of authorization in lieu of signed contracts or agreements.
- Transactions with related parties.
- Barter transactions.
- The existence of “side-agreements.”

Potential accounting errors:

- Sales in which evidence indicates the customer’s obligation to pay for the merchandise depends on:
 - receipt of financing from another (third) party;
 - resale to another (third) party (i.e., sale to distributor, consignment sale); or
 - fulfillment by the seller of material unsatisfied conditions.
- Sales of merchandise that are shipped in advance of the scheduled shipment date without evidence of the customer’s agreement or consent.
- Pre-invoicing of goods that are in the process of being assembled or invoicing prior to, or in the absence of, actual shipments.
- Shipments are made after the end of the period (i.e., books kept open to record revenue for products shipped after the period end).
- Sales are not based on actual (firm) orders to buy.
- Shipments are made on canceled or duplicate orders.

- Shipments are made to a warehouse or other intermediary location without the instruction of the customer.
- Shipments that are sent to and held by freight forwarders pending return to the company for required customer modifications.
- Altered dates on contracts or shipping documents.

Planning Considerations

.04 To reduce the risk of improper revenue recognition, the audit needs to be planned and executed with an appropriate degree of professional skepticism. In planning the audit, the auditor should obtain a sufficient understanding of the client's industry and business, its products, its marketing and sales policies and strategies, its internal control structure, and its accounting policies and procedures related to revenue recognition.

.05 This understanding should include the procedures for receiving and accepting orders, shipping goods, relieving inventory, and billing and recording sales transactions. A sufficient understanding of a client's policies with respect to acceptable terms of sale and an evaluation of when revenue recognition is appropriate given those terms is essential. It is also essential that the auditor have an understanding of the computer applications and key documents (e.g., purchase orders, shipping reports, bills of lading, invoices, credit memos, etc.) used during the processing of revenue transactions.

.06 An understanding of the revenue cycle is particularly important when the company has new product or service introductions or begins new sales arrangements. New products may not work as envisioned nor receive customer acceptance as expected. Sales terms might differ from the company's customary terms and both the client's employees and the auditor may need to obtain an understanding of new procedures.

.07 An understanding of the revenue cycle is also important when reviewing sales to distributors. In considering the appropriateness of revenue recognition on such sales, auditors should consider inquiring as to whether the client has offered to assist the distributor in placing the product with end users. The auditor also should consider inquiring as to whether concessions have been made with the distributor in the form of return product rights or other arrangements. In considering the appropriateness of recognizing revenue on sales to distributors, the auditor should bear in mind that a sale is not final until the customer accepts the product and the risks and rewards of ownership have been transferred to the buyer.

.08 The auditor's knowledge base of the revenue recognition cycle provides a perspective or mindset for determining the nature, timing, and extent of audit procedures to be applied. For example, a company operating in a declining industry or one characterized by frequent business failures ordinarily will present different audit considerations and may require different or more extensive audit procedures than a company operating in a healthy industry. Similarly, the risk of management misrepresentation may be greater when management's compensation is based to a significant degree on reported earnings or when management places undue emphasis on meeting analysts' earnings projections. Even when additional revenues do not contribute much to earnings (e.g., immature companies operating at a loss), recognize that many of these companies are valued based on increased revenues. Risk also

may be heightened when there are frequent disputes or disagreements with management concerning the aggressive application of accounting principles. Statement on Auditing Standards (SAS) No. 82, *Consideration of Fraud in a Financial Statement Audit*, provides factors to consider when assessing the risk of material misstatements or management misrepresentations.

.09 A proper understanding of a client's business, its accounting policies and procedures, and the nature of its transactions with customers is also useful in assessing the extent of experience or supervision required of the personnel assigned to audit revenue transactions. Certain unusual or complex sales contracts may signal the need for more experienced engagement personnel.

.10 The performance of well-planned analytical procedures during the audit planning process and in executing the audit itself (such as, a comparison of sales and customer receivable cash collections to corresponding periods of the prior year and to budgeted amounts; a review of monthly and/or quarterly sales volume analyses; a review of sales credits and returns subsequent to year-end; and comparisons of agings of accounts receivable portfolios in the current and prior periods) may assist the auditor in identifying situations that warrant additional consideration. A company constantly increasing sales that "always meets or exceeds" budgeted sales targets and that result in the "build-up" of accounts receivable may warrant extra attention. When a substantial portion of the company's sales occur at the end of the accounting period, extra caution in auditing revenue transactions is appropriate. Also, individually significant revenue transactions, which could be designed to ease short-term profit concerns, may merit specific attention. Caution should also be exercised when "bill and hold" sales exist. Auditors need to examine such transactions and obtain an understanding of the transaction's business purpose to evaluate whether revenue recognition is appropriate.

Confirmations and Management Representations

.11 Unusual or complex revenue transactions may increase audit risk. Consequently, the auditor should consider the need to perform additional audit procedures to assess the propriety of revenue recognition of such transactions. Discussion with representatives of the client's sales, marketing, customer service and returns departments may often be appropriate. Other examples of additional audit procedures to consider may include confirmation of sales terms, review of sales contracts, or the use of a specialist to interpret contractual agreements.

.12 Standard confirmation requests (which typically confirm only the outstanding balance) may not always provide sufficient audit evidence to determine whether revenue transactions have been recorded appropriately. A recent SEC Accounting and Auditing Enforcement Release (No. 1044) stated that "generally accepted auditing standards advises that material year-end transactions be tested by confirming information about the transactions underlying the accounts receivable balance." Confirmations can be designed to help the auditor solicit information from customers about payment terms, right-of-return privileges, continuing obligations on the part of the client, or other significant risks retained by the client. In determining the information to confirm, an understanding of the client's arrangements and transactions with customers is essential. If the auditor is aware of unusual arrangements or transactions (e.g., "bill and hold" or significant or unusual software licenses),

confirmations can be used to corroborate the terms of the agreements and inquire about the existence of any oral modifications or undocumented "side-agreements" (e.g., unusual payment terms, liberal rights of return). When the arrangements are complex or unusual, auditors are well advised to consider the business purpose of the transactions from the perspectives of both the seller and the buyer, and evaluate responses to inquiries with appropriate professional skepticism. Also, because of the increased risk presented by individually significant revenue transactions, the auditor should consider confirming the terms of those individual sales.

.13 SAS No. 85, *Management Representations*, requires the auditor to obtain written representations from management relating to the following: financial statements; completeness of information; recognition, measurement and disclosure; and subsequent events. Although representations from management are not a substitute for application of audit procedures designed to afford a reasonable basis for an opinion on the financial statements, the auditor may consider it useful to obtain written representations concerning specific revenue recognition issues, such as the terms and conditions of unusual or complex sales agreements.

.14 Such representations may include confirmation that there are no contingencies that affect the obligation of customers to pay for merchandise purchased, and may also include confirmation regarding the existence of side agreements. This is particularly important when it is common industry practice to provide customers with certain rights of return or other privileges (e.g., in high-technology enterprises). In addition to obtaining representations from management, auditors should consider making inquiries of others familiar with the transactions (e.g., sales personnel), aside from the accounting and finance personnel, and consider whether there is a need to also obtain written representations from those individuals.

Accounting Considerations

.15 Revenue is defined in FASB Concept Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*, paragraph 83, as follows:

Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, sometimes one and sometimes the other being the more important consideration.

.16 Additional guidance with respect to revenue recognition is found in the following pronouncements:

- Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*;
- Statement of Financial Accounting Standards No. 48, *Revenue Recognition When Right of Return Exists*;
- AICPA Statement of Position (SOP) 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330];
- AICPA SOP 97-2, *Software Revenue Recognition* [section 10,700];

- SEC Accounting and Auditing Enforcement Release No. 108 (states that recognition of revenue on “bill and hold” transactions, prior to shipment or exchange with the customer, is a departure from the “general rule of revenue recognition,” and is appropriate only if certain conditions described in Release No. 108 are met); and
- Various other Emerging Issues Task Force abstracts which provide guidance on specific revenue recognition issues.

Communications with Board of Directors/ Audit Committees

.17 Shareholders rely on the board of directors and its audit committee to monitor company performance and make decisions that serve the best interests of the company and its shareholders. SAS No. 61, *Communication with Audit Committees*, requires the auditor to ensure that the audit committee (defined as those parties who have oversight of the financial reporting process) receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible. SAS No. 61 states that certain matters are required to be communicated, as follows: significant accounting policies, management judgments and accounting estimates, significant audit adjustments, other information in documents containing audited financial statements, disagreements with management, consultation with other accountants, major issues discussed with management prior to retention and difficulties encountered in performing the audit.

.18 The communication by the auditor to the board of directors/audit committee should include a discussion related to revenue recognition practices of the company, including matters such as a change in the company’s revenue recognition policy, a lack of involvement by the accounting/finance department in sales transactions or in the monitoring of arrangements with distributors, significant sales or volume of sales that are recorded at or near the end of the reporting period, sales terms that do not comply with the company’s normal policies, etc. The SEC Practice Section has developed best practices guidance on communications with board of directors/audit committees, which includes recommendations regarding the following:

- The establishment of firm policies and procedures for communications with board of directors/audit committees.
- The establishment of a relationship with board of directors/audit committees which fosters candid and open discussions.
- The nature of communication by the auditor regarding the qualitative assessment of the company’s accounting principles and the clarity of the company’s financial statement disclosures.
- The timing of when such communications should occur.

The SEC Practice Section best practices guidance can be obtained from the AICPA Web site www.aicpa.org/members/div/secpa/lit/best/index.htm.

Conclusion

.19 No audit can be designed to provide absolute assurance that all revenue recorded by the client is appropriate or that fraudulent financial reporting

is discovered. However, an awareness of conditions that increase audit risk, along with an appropriate skeptical response to issues identified during the planing process and during the performance of significant field work, can help auditors increase the likelihood that either inadvertent or intentional material misstatements of revenue will be detected.

[The next page is 50,891.]

Section 16,130

Practice Alert 99-1 **Guidance for Independence Discussions With** **Audit Committees**

May, 1999

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing audit literature, the professional experience of the members of the AICPA SEC Practice Section Professional Issues Task Force (PITF) and information provided by AICPA SEC Practice Section member firms to their own professional staff. The information in this Practice Alert represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used by practitioners with the understanding that it be read in conjunction with the professional literature and only as a means of assisting them in meeting their professional responsibilities.

.01 In January 1999, the Independence Standards Board (ISB) adopted Independence Standard No. 1, *Independence Discussions with Audit Committees* (the "Standard"). The Standard states that it applies to any auditor intending to be considered an independent accountant within the meaning of the Securities Acts administered by the Securities and Exchange Commission (SEC). This should be considered to include an auditor with respect to any entity for which his or her engagement is required to comply with SEC Regulation S-X.¹ The Standard requires annual written and oral communications between the auditor and the audit committee (or the board of directors if there is no audit committee) of a public company client regarding relationships that, in the auditor's professional judgment, may reasonably be thought to bear on independence, as well as written confirmation that the auditor is independent of the company within the meaning of the Securities Acts. Such communications are required with respect to audits of entities with fiscal years ending after July 15, 1999, with earlier application encouraged.

.02 The Standard can be obtained from the ISB website at www.cpaIndependence.org. The ISB has expressed its belief that the Standard will improve corporate governance by affording to audit committees a mandated opportunity to deepen their understanding of auditor independence issues. The ISB believes the Standard will assist directors in satisfying themselves that the

¹ The Standard applies to auditors of domestic and foreign registrants. The Standard would also apply where a regulatory agency (such as the Office of the Comptroller of the Currency (OCC)) undertakes to have auditors of entities under its jurisdiction comply with SEC Independence Rules. It is noted that an auditor might contractually obligate himself or herself to follow Regulation S-X. An example might be a private company intending to have a public offering in the future and the desire of management to have the auditor meet all SEC requirements.

company has engaged “independent” accountants as required by the Securities Acts. The ISB also believes that a mandate that audit firms describe and discuss the judgmental matters that might impact on independence will bring more focus within the firms on this important issue.

.03 Additionally, *The Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees* (the “Blue Ribbon Committee Report”), issued in February 1999, included a recommendation that the listing rules for both the New York Stock Exchange and the National Association of Securities Dealers require audit committee charters to specify that the audit committee is responsible for ensuring receipt of the communication required by the Standard.

.04 This recommendation also indicated the charter should specify that the audit committee is responsible for actively engaging in a dialogue with the auditors relating to the disclosure of any relationships or services that may impact the objectivity and independence of the auditor and should take appropriate action, if necessary, to ensure the continued independence of the auditor. To address implementation issues relative to the Standard, the Professional Issues Task Force of the AICPA SEC Practice Section (PITF) has been asked to develop initial guidance for CPA firms. The guidance in this PITF Alert is designed to assist firms in evaluating and enhancing their policies and procedures for identifying and communicating with audit committees those judgmental matters that may reasonably be thought to bear on the auditor’s independence.

.05 These communications in turn should serve to assist audit committees/boards of directors in fulfilling certain of their responsibilities relative to corporate governance. These communications also will assist auditors in fulfilling their responsibilities to serve the interests of the public and strengthen the public’s confidence in audited financial information reported by registrants. The following discussion is in the context of communications between the auditor and the audit committee/board of directors. This should not be construed as precluding the auditor from having similar communications with senior management. Indeed, the PITF encourages such communications.

Firm Policies and Procedures

.06 Firms should establish policies and procedures relating to independence communications with audit committees. These policies and procedures should be distributed to all professional staff to enhance their awareness of independence issues and reaffirm professional standards. The following information may be a useful framework for developing these policies and procedures.

Determination of Matters to Be Communicated

.07 The Standard requires auditors to communicate, in writing, at least annually all relationships between the auditor and the company that, in the auditor’s professional judgment, may reasonably be thought to bear on independence. In determining which relationships to discuss, the auditor should not conclude that a relationship need not be disclosed solely because he or she has concluded that independence is not impaired. The auditor should consider whether the audit committee, which, as stated in the Blue Ribbon Committee Report, may be viewed as a “guardian of investor interests and corporate accountability,” would consider the disclosure and discussion of the relationship beneficial to further its understanding of auditor independence in the company’s specific circumstances. While the decision regarding the matters to

Guidance for Independence Discussions With Audit Committees **50,893**

be communicated will vary in each circumstance, and that decision is ultimately the auditor's, consideration should be given to communicating and discussing with the audit committee all non-audit services that the auditor has agreed to perform for the client.

.08 Exhibit A provides examples of certain relationships that, depending on the specific facts and circumstances, may commonly be thought to bear on the auditor's independence. Exhibit A also includes relevant safeguards to ensure the auditor's continued independence.

Exhibit A

**Consideration of Relationships and Other Matters
That May Bear on Independence**

This Exhibit provides examples of relationships that, depending on the specific facts and circumstances, may reasonably be thought to bear on independence, along with typical safeguards that, if in place, may mitigate threats to the auditor's independence. The information that follows may be used as a guide in determining the types of relationships that may be disclosed by the auditor. These examples should not be considered all-inclusive, nor should it be construed that the example relationships would be required to be disclosed by all auditors in all cases.

Employment.²

Disclosure of Relationship: The former audit engagement partner joined the audit client as Vice President and Chief Financial Officer.

Safeguards: The accounting firm conducted a review of all services for this client that were performed by the former partner for an appropriate period preceding the employment offer and did not note any matters which would cause the firm to believe the former partner and the firm were not independent of the company. The accounting firm performed a review of the appropriateness of the assignments of the succeeding engagement partner and concurring review partner and considered the need for involvement of other partners with appropriate experience and stature to ensure an appropriate level of professional skepticism is maintained.

In addition, the accounting firm and the former partner have severed all relationships, including settlement of the former partner's capital account and settlement of retirement benefits to the extent required by the SEC's independence rules.

Disclosure of Relationship: The former audit engagement manager joined the audit client as Controller.

Safeguards: The accounting firm conducted a review of all services for this client that were performed by the former manager for an appropriate period preceding the employment offer and did not note any matters which would cause the firm to believe the former manager and the firm were not independent of the company. The accounting firm performed a review of the appropriateness of the assignment of the remaining engagement team to ensure that an appropriate level of professional skepticism is maintained.

Disclosure of Relationship: The office managing partner in the local office of the accounting firm accepted a position with the audit client as Chief Operating Officer. Such partner provided no professional services to the company prior to his/her employment.

Safeguards: The accounting firm performed a review of the appropriateness of the assignments of engagement partner and concurring review partner and considered the need for involvement of other partners with appropriate experience and stature to ensure an appropriate level of professional

(continued)

² On March 12, 1999, the ISB issued a Discussion Memorandum, *Employment with Audit Clients*, to seek comments on a variety of independence issues when audit firm personnel accept employment with audit clients. Practitioners should be alert for developments in this area.

Exhibit A—continued

skepticism is maintained. In addition, the accounting firm and the former partner have severed all relationships, including settlement of the former partner's capital account and settlement of retirement benefits to the extent required by the SEC's independence rules.

Family Relationships:

Disclosure of Relationship: The audit client's Controller is the wife of a manager in the accounting firm's [city] office.

Safeguards: The accounting firm's manager will be restricted from performing any work for the audit client and his office will not participate in a significant portion of the audit engagement. All of the work on the engagement for the audit client will be performed by the accounting firm's office in [other city].

Disclosure of Relationship: One of the accounting firm's partners has a brother who is a director of the audit client.

Safeguards: Neither the partner nor the office to which he is assigned has any involvement in the accounting firm's engagement for the audit client. Further, the partner and his office are adequately geographically separated from both the residence of his brother and the office of the accounting firm performing the work on the engagement.

Non-audit Services:

Disclosure of Relationship: The accounting firm has been engaged to perform the following non-audit services:

- Extended audit services by outsourcing the internal audit function. Annual fees for this engagement are approximately [amount of fees].
- Assistance in the implementation of an accounting system [describe the system implemented]. Fees for this engagement were approximately [amount of fees].

Safeguards: In each case, management of the audit client has sufficient expertise to take responsibility for all management decisions that will be made and the accounting firm will not assume the role of an employee or of management of the audit client.

Other Separate Business Arrangements Involving Mutual Clients:

Disclosure of Relationship: The accounting firm and the audit client entered into separate business arrangements to provide advisory and consulting services which dealt with [describe nature of accounting firm's services] to a mutual third party. Fees for such services totaled approximately [amount of accounting firm's fees].

Safeguards: We believe this engagement does not constitute doing business with the client. In proposing for the services, the role of the accounting firm and the audit client were clearly defined through the use of separate proposals indicating the services for which each party was responsible. The third party has contracted separately with the accounting firm and the audit client such that neither party is dependent on the other party's performance and each party's liability and contractual obligations are separate.

Engaging the Audit Committee

.09 While the auditor must make the decision as to what is reported to the audit committee, engaging the audit committee chair in discussions regarding his or her views on relationships that may reasonably be thought to bear on independence may be a worthwhile approach to begin the process. If this approach is used, the audit committee chair should be asked by the auditor to express his or her views and concerns regarding the types of relationships that may reasonably be thought to bear on independence and, accordingly, would be expected to be disclosed. It is reasonable to assume that expectations may vary from company to company and the level of sensitivity as to independence issues may vary as well. These discussions should foster an open channel of communication between the parties relative to independence and other matters and should assist the auditor in understanding the audit committee's expectations regarding the types of relationships to be discussed.

.10 While the PITF believes these discussions are worthwhile and should facilitate a meaningful discussion with the audit committee, in the final analysis, it is the auditor's judgment that must prevail with respect to the matters that get reported and discussed with the audit committee. Exhibit B provides the form of a sample letter to the audit committee chair that could be used to initiate these discussions.

Exhibit B

Sample Letter to Audit Committee Chair

July 15, 19x9
Mr. [or Ms.] Smith
Audit Committee Chair
Blank Company
Main Street
City, State Zip Code

Dear Mr. [or Ms.] Smith:

In January 1999, the Independence Standards Board adopted Independence Standard No. 1, Independence Discussions with Audit Committees (the "Standard"). The Standard requires annual written and oral communications between our Firm and the Audit Committee of Blank Company regarding relationships that in our professional judgment may reasonably be thought to bear on our independence. Additionally, The Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees issued in February 1999 included a recommendation that the listing rules for both the New York Stock Exchange and the National Association of Securities Dealers require audit committee charters to specify that the audit committee is responsible for ensuring receipt of the communication required by the Standard. This recommendation also indicated the charter should specify that the audit committee is responsible for actively engaging in a dialogue with the auditors relating to the disclosure of any relationships or services that may reasonably be thought by the auditor to bear on independence and should take appropriate action, if necessary, to ensure the continued independence of the auditor.

In order to facilitate our independence discussions with the Audit Committee, I would like to meet with you to obtain an understanding of the expectations of you and the Audit Committee with respect to the types of matters and relationships between our Firm and Blank Company that you believe may bear on our independence. These may include specific areas of interest to you and the Audit Committee, as well as matters the Audit Committee and senior management believe should be considered because they may be of interest to the Audit Committee as a representative of Blank Company's investors.

I would be pleased to meet with you at your convenience to discuss your thoughts and views on auditor independence and related matters.

Yours truly,

Threats to Objectivity and Related Safeguards

.11 To assist audit committees in expanding their understanding of auditor independence issues, auditors are encouraged to periodically discuss emerging independence issues and new or revised independence standards.

.12 To further assist these discussions, auditors also may consider providing the audit committee with an overview of common threats to auditor objectivity. While independence standards are designed to preclude relationships that may appear to impair an auditor's objectivity, additional safeguards have been developed by firms and the profession, and other external factors exist, that further mitigate threats to actual loss of objectivity.

.13 Exhibit C provides a summary of common threats to auditor objectivity and related safeguards that mitigate these threats.

Exhibit C

Common Threats to Auditor Objectivity and Related Safeguards Often Employed to Mitigate These Threats

Common Threats to Auditor Objectivity:

- **Self-Interest:** The threat to the auditor's objectivity due to financial or other self-interests.
- **Self-Review:** The threat to the auditor's objectivity caused by a self-review of services performed by the auditor or the auditor's firm during the audit.
- **Advocacy:** The threat to the auditor's objectivity if the auditor becomes an advocate for (or against) the client's position.
- **Familiarity or Trust:** The threat of the auditor becoming too trusting of the client and therefore not maintaining appropriate professional skepticism.
- **Intimidation:** The threat of the auditor becoming intimidated or threatened by an overbearing or dominating member(s) of management.

Related Safeguards Often Employed to Mitigate These Threats:

Instilling Professional Values:

- Training
- Firm Policies on Independence
- Monitoring Investments
- Annual Confirmations of Compliance with Firm Independence Policies

Communication:

- Audit Team Disagreement Resolution Process
- Consultation Requirements
- Separate National Consultation Function

Internal Accountability:

- Partner Rotation
- Concurring Partner Reviews
- Internal Inspection/Monitoring Programs
- Analysis of Regulatory and Litigation Experience
- Internal Disciplinary Actions
- Partner and Staff Evaluation and Compensation Methods

Risk Management:

- Client Acceptance and Retention Policies
- New Service Line Acceptance Policies

External Factors:

- Peer Review
- Quality Control Inquiry Committee (QCIC) Review
- Ethics Investigations (by the AICPA, state societies and state boards)
- SEC Enforcement Division
- Litigation Threat
- Reputational Threat

Form of Communication

.14 Communications from the auditor to the audit committee should disclose the relationships identified that may reasonably be thought to bear on independence. Disclosure should not be construed to imply that the auditor's independence has been impaired. In fact, it is presumed that the auditor has concluded that independence has not been impaired. Rather, disclosure of the relationships is a tool to foster discussion between the auditor and the audit committee regarding the nature of the relationship.

.15 The Standard requires that written communications summarize the relationship(s) identified. The auditor may wish to include in its written communications the relevant safeguards employed by the firm (see Exhibit A) to ensure the auditor's continued independence. Oral communications should include an open candid discussion relating to the relationship and a discussion of the relevant safeguards.

.16 The Standard also requires that the written communication include a confirmation that, in the auditor's professional judgment, the auditor is independent of the company within the meaning of the Securities Acts.

.17 Exhibit D provides the form of a sample letter relating to annual independence discussions with audit committees and confirmation that the auditor is independent of the company within the meaning of the Securities Acts.

Exhibit D

**Sample Letter Relating to Annual Independence
Discussions with Audit Committees**

September 15, 19x9
The Audit Committee [or the Board of Directors]
Blank Company
Main Street
City, State Zip Code

Dear Audit Committee Members:

We have been engaged to audit the consolidated financial statements of Blank Company (the "Company") for the year ending December 31, 19x9.

Our professional standards require that we communicate at least annually with you regarding all relationships between our Firm and the Company that, in our professional judgment, may reasonably be thought to bear on our independence. [We have previously communicated with Mr./Ms. Smith, Chair of the Audit Committee, to obtain his/her views as to the nature of the matters that should be reported to the Audit Committee.] We have prepared the following comments to facilitate our discussion with you regarding independence matters. [After the initial year, this last sentence might be revised to read: "We have prepared the following comments to facilitate our discussion with you regarding independence matters arising since September 15, 19x9, the date of our last letter."]

We are aware of the following relationships between our Firm and the Company that, in our professional judgment, may reasonably be thought to bear on our independence. The following relationships represent matters that have occurred during 19x9, the initial year of adoption, through September 15, 19x9.

[Describe any significant relationships or matters bearing on the Firm's independence, and also discuss the appropriate safeguards in place. See Exhibit A for examples.]

[OR]

We are not aware of any relationships between our Firm and the Company that, in our professional judgment, may reasonably be thought to bear on our independence which have occurred during 19x9, the initial year of adoption, through September 15, 19x9.

We hereby confirm that as of September 15, 19x9, we are independent accountants with respect to the Company, within the meaning of the Securities Acts administered by the Securities and Exchange Commission and the requirements of the Independence Standards Board.

This report is intended solely for the use of the Audit Committee, the Board of Directors, management, and others within the Company and should not be used for any other purposes.

We look forward to discussing with you the matters addressed in this letter as well as other matters that may be of interest to you at our upcoming meeting on September 30, 19x9. We will be prepared to answer any questions you may have regarding our independence as well as other matters.

Yours truly,

.18 While this Alert focuses on the Standard, it is recognized that communications with audit committees, whether written or oral, are broader than independence. For example, membership requirements of the AICPA SEC Practice Section require annual communication of the nature of and the amount of fees billed for management advisory [consulting] services. Generally accepted auditing standards require communications of matters regarding internal control, including material weaknesses identified, and various other matters.

.19 The recently issued Blue Ribbon Committee Report contains recommendations that will likely result in additional required discussions with audit committees, including dialogue on accounting principles. Without in any way reducing the importance of the independence discussion, the auditor may choose a more comprehensive form of communication to cover some or all of these other matters.

Timing of Discussions with Audit Committees

.20 Annually, the auditor should meet with the audit committee to discuss all applicable relationships (actual and, preferably, proposed) between the company and the auditor. It may be beneficial to establish a schedule of regular meetings to discuss independence matters with the audit committee, including the timing for the annual independence confirmation. To enhance the effectiveness of the process, early communication to the audit committee of significant new matters might be considered at the time the relationship is established or the matter is first identified, rather than waiting until the meeting.

.21 The annual meeting desirably should be conducted as early as possible in the audit cycle. However, it should be noted that the ISB intentionally left the timing flexible as long as the communication is done annually. It is entirely acceptable to have the communication at any time, preferably prior to the issuance of the auditor's report. If the formal communication takes place early in the audit cycle, the auditor and the audit committee should establish a protocol to update the audit committee for any new or proposed relationships requiring communication that may have occurred since the initial communication.

.22 If the formal communication takes place near the end of the audit cycle, it may be desirable to combine the independence discussions with other required communications.

Other Matters

Initial Public Offerings

.23 Auditors and audit committees of first time registrants must comply with the Standard prior to the company's initial public offering. These communications are required for all audits of financial statements with fiscal years ending after July 15, 1999, and included in the registration statement in the company's initial public offering. Thus, this may require involvement of both the current auditor and a predecessor auditor, if there has been a change of auditors during this period. Early communication between the auditor and the audit committee is encouraged to proactively identify and resolve any potential issues regarding the auditor's independence early in the offering process.

Initial Year of Application

.24 The Standard requires annual discussion between the auditor and the audit committee. For existing registrants in the initial year of application, these discussions are only required to cover relationships that exist in the current year. Thus, where a change of auditor has occurred, the discussions would only require involvement of the current auditor.

Prospective Clients

.25 Auditors are encouraged to discuss relationships that may exist with prospective clients during the proposal process. Discussion should include identification of the relationship, a discussion of safeguards that may mitigate these threats and, where necessary, identification of the methods to resolve potential impairments of independence prior to commencement of the audit.

Failure to Comply with the Standard

.26 The ISB recognized the possibility that there might be occasions where the required communications are not completed. This could occur for a variety of reasons, including unexpected cancellation of a scheduled meeting with the audit committee, or the inadvertent failure to schedule and complete the meeting or the auditor's failure to issue a written confirmation of its independence with respect to the company.

.27 The ISB did not intend that an isolated and inadvertent violation of the Standard's requirements would constitute a per se impairment of the auditor's independence, provided that the auditor is in compliance with all other independence rules. The ISB specifically recognized that in such circumstances, the violation could be "cured" through the prompt completion of the procedures. In the unlikely event that the auditor encounters difficulty in completing these procedures either initially or at the time a "cure" is attempted, prompt communication with the audit committee and the board of directors should be undertaken to highlight the effect of the failure to comply with the Standard on the company.

.28 The ISB also recognized that the auditor could, but is not required to, withhold his or her audit report until such discussion with the audit committee took place.

[The next page is 50,911.]

Section 16,140

Practice Alert 99-2 **How the Use of a Service Organization** **Affects Internal Control Considerations**

July/August 1999

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing audit literature, the professional experience of the members of the Professional Issues Task Force (PITF) and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with the professional literature and that it is only a means of assisting auditors in meeting their professional responsibilities.

Introduction

.01 Obtaining a Statement on Auditing Standards (SAS) No. 70 report may be an efficient means of satisfying the requirements of generally accepted auditing standards (GAAS) with respect to service organizations. There have been recent examples of situations where a user organization's auditor did not obtain a SAS No. 70 report and did not employ alternative approaches to obtaining the necessary information. There also have been recent examples where a SAS No. 70 report was obtained but the report was not sufficient for the user auditor's purposes or was not needed. This may result from the user auditor not having a sufficient understanding of SAS No. 70, *Service Organizations*, or the different types of SAS No. 70 reports that are issued (i.e., Type 1 and Type 2 reports). Today, more and more companies are outsourcing activities to service organizations. In doing so, there often is a belief by the user organization that the service organization can be totally relied upon and that the user organization needs only to provide very limited, if any, controls. It is in these situations that it is critical for the user auditor to consider the guidance in SAS No. 70 and the implications the service organization may have to his/her audit.

.02 Many companies and organizations use outside service organizations to provide services ranging from performing specific tasks (such as maintaining custody of marketable securities) to replacing entire departments (such as performing all computer processing). They generally use such organizations because they do not have the internal expertise or skills to perform the services or it is cost effective to outsource the service. Examples of service organizations are:

- Data processing service organizations that perform such services as payroll, billing, general ledger accounting and other administrative functions.
- Trust departments of financial service companies.
- Mortgage loan servicers.
- Organizations providing services for employee benefit plans, such as providing investment management, custody of investments, record keeping of employee or participant data, processing employee benefit claims, and other accounting or administrative functions.

Factors to Consider in Planning an Audit

.03 Professional standards require that the auditor obtain an understanding of an entity's internal controls sufficient to plan the audit. The understanding is obtained by performing procedures to gain knowledge about the design of the controls relevant to the audit of the financial statements and whether they have been placed in operation. The requirement to understand internal control may extend beyond the controls in place at the entity's physical environment and may extend to other organizations who perform services on behalf of the entity to assist it in the recording, processing, summarizing and reporting of information in its financial statements. SAS No. 70 provides guidance for auditing an entity when a service organization's services are part of the user organization's information system.

When the User Auditor's Planning Should Consider the Guidance in SAS No. 70

.04 A user auditor should consider the guidance in SAS No. 70 whenever a service organization's services are part of the user organization's information system. A service organization's services would meet that criterion if they affect:

- How the user organization's transactions are initiated.
- The accounting records, supporting information, and specific accounts in the financial statements involved in the processing and reporting of the user organization's transactions.
- The accounting processing involved from the initiation of the transactions to their inclusion in the financial statements.
- The financial reporting process used to prepare the user organization's financial statements, including significant accounting estimates and disclosures.
- The guidance in SAS No. 70 does not relate to an entity that obtains a service from another organization that is limited to executing a client's transactions that are authorized by the client. Examples of such services are when a bank processes checking account transactions and when a broker processes securities transactions that are initiated by the client.
- The significance of the service organization's controls depends primarily on the nature and materiality of the transactions it processes for

the user organization and the degree of interaction between the internal controls at the user organization and the controls at the service organization.

Nature and Materiality of the Transactions

.05 If the transactions processed or accounts affected by the service organization are material to the user organization's financial statements, the user auditor may need to obtain an understanding of the controls at the service organization. In certain situations, the transactions processed and accounts affected may not appear to be material to the user organization's financial statements, but the nature of the transactions processed may require that the user auditor obtain an understanding of those controls. Such a situation might exist when a service organization provides third-party administration services to self-insured organizations providing health insurance benefits to employees. Although transactions processed and accounts affected may not appear to be material to the user organization's financial statements, the user auditor may need to gain an understanding of the controls at the third-party administrator because improper processing may result in a material understatement of the liability for unpaid claims.

.06 Information about the nature of the service provided by a service organization may be available from a variety of sources, such as SAS No. 70 reports by service auditors, user manuals, system overviews, technical manuals, the contract between the user organization and the service organization, and reports by internal auditors, or regulatory authorities on the service organization's controls.

Degree of Interaction

.07 The degree of interaction relates to the extent to which a user organization is able to and decides to implement effective internal controls over the processing performed by the service organization and on the nature of the services provided by the service organization.

.08 If the user organization implements highly effective internal controls over the processing of transactions at the service organization, the user auditor may not need to gain an understanding of the controls at the service organization in order to plan the audit. For example, if the user organization has such controls, the user auditor could obtain an understanding of the controls by performing a walkthrough at his/her client.

.09 If the user organization has a low degree of interaction and has not placed into operation effective internal controls over the activities of the service organization, the user auditor would most likely need to gain an understanding of the relevant controls at the service organization in order to plan the audit in accordance with GAAS.

.10 If the user organization relies on controls at the service organization to prevent or detect errors that would have an impact on its financial statements, the user auditor must understand those controls.

.11 The understanding of the service organization should include an understanding of the control environment, risk assessment, control activities,

information and communication and monitoring relevant to the audit of the client's financial statements. The understanding should include knowledge about the design of the controls and whether they have been placed in operation. The understanding of the controls should enable the user auditor to:

- Identify the types of potential misstatements that could occur in the client financial statements.
- Consider the factors that affect the risk of misstatement.
- Design substantive tests.

Failure to obtain such an understanding from either the client or the service organization may cause the user auditor to consider whether a scope limitation on the audit has occurred.

Factors to Consider in Assessing Control Risk

.12 After the user auditor obtains an understanding of the relevant controls at both the user organization and the service organization and considers the factors that affect the risk of material misstatement, he or she should assess control risk for the financial statement assertions. As previously stated, if the user organization has implemented certain controls over the service organization's activities that effectively operate to prevent or detect material misstatements in its financial statements, the user auditor may be able to perform the audit without identifying and testing controls at the service organization.

.13 Generally, the user auditor can identify relevant controls at a service organization by reading the service auditor's report, either a Type 1 or Type 2 report. Information about the operating effectiveness of the controls at the service organization are only included in a Type 2 report. Control risk can only be assessed below the maximum, if evidential matter is obtained using one or a combination of the following ways:

- By testing the user organization's controls over the activities of the service organization.
- By obtaining a service auditor's report (Type 2) on controls placed in operation and tests of operating effectiveness, or a report on the application of agreed-upon procedures that describes relevant tests of controls.
- By the user auditor performing appropriate tests of controls at the service organization.

Following is a further discussion of when each of these activities may apply.

.14 The user organization may establish effective controls over the service organization's activities that may be tested and that may enable the user auditor to reduce the assessed level of control risk below the maximum for some or all of the related assertions. For example, if a user organization uses an EDP service center to process payroll transactions, the user organization may establish controls over input and output data to prevent or detect material misstatements. The user organization might recalculate the service organization's payroll computations on a test basis. In this situation, the user auditor may perform tests of the user organization's controls over data processing that would provide a basis for assessing control risk below the maximum for the assertions related to payroll transactions. The user auditor may decide that obtaining evidence of the operating effectiveness of the service organization's controls, such as those over changes in payroll programs, is not necessary or efficient.

.15 The user auditor may find that controls relevant to assessing control risk below the maximum for the particular assertions are applied only at the service organization. If the user auditor plans to assess control risk below the maximum for specified assertions, the user auditor should obtain evidence of the operating effectiveness of these controls by obtaining and evaluating a service auditor's report that describes the results of the service auditor's tests of those controls, or by performing tests of controls at the service organization.

.16 If the user auditor decides to use a service auditor's report, the user auditor should consider the extent of the evidence provided by the report concerning the effectiveness of controls intended to prevent or detect material misstatements regarding the particular assertions. The user auditor remains responsible for evaluating the evidence presented by the service auditor and for determining the effect of this evidence on the assessment of control risk at the user organization.

.17 Because SAS No. 70 reports may be intended to satisfy the needs of several different user auditors, a user auditor should determine whether the specific tests of controls and results in the service auditor's reports are relevant to assertions that are significant in the user organization's financial statements. For those tests of controls and results that are relevant, a user auditor should consider whether the nature, timing and extent of such tests of controls and results provide sufficient evidence about the effectiveness of the controls to support the user auditor's desired assessment of the level of control risk. In evaluating these factors, the user auditor should also keep in mind that the shorter the time period covered by the tests of controls and the longer the time elapsed since the performance of the tests, the less support for control risk reduction the tests may provide.

SAS No. 70 Reports

Types of Reports

.18 There are two types of SAS No. 70 reports:

- Reports on controls placed in operation (Type 1). Such a report may provide a user auditor with an understanding of the controls in operation at a service organization and whether they are suitably designed to achieve specific control objectives. A Type 1 report may be useful in providing the user auditor with an understanding of controls necessary to plan the audit and to design effective tests of controls and substantive tests at the user organization, but it is not intended to provide the user auditor with a basis for reducing his/her assessment of control risk below the maximum.
- Reports on controls placed in operation and tests of operating effectiveness (Type 2). Such a report may provide the user auditor with an understanding of controls in operation at a service organization and whether they are suitably designed to achieve specific control objectives. Also, a Type 2 report indicates whether the controls that were tested were operating with sufficient effectiveness to provide reasonable assurance that the control objectives were achieved. This report may provide the user auditor with an understanding of controls necessary to plan the audit and may also provide a basis for reducing his/her assessment of control risk below the maximum.

What Is Included in the Reports

.19 A SAS No. 70 report typically includes the following items:

- Service organization's description of controls placed in operation as of a specific date.
- Service organization's description of the specified control objectives.
- Auditor's opinion on whether the description presents fairly, in all material respects, the relevant aspects of the service organization's controls that had been placed in operation as of a specified date.
- Auditor's opinion on whether the controls were suitably designed to provide reasonable assurance that the specified control objectives would be achieved if those controls were complied with satisfactorily.
- Auditor's opinion as to whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the control objectives specified in the report were achieved during the specified period (Type 2 reports only).

Considerations in Using the Reports

.20 After determining the need for a SAS No. 70 report, some auditors have a tendency to simply obtain the report and place it in the audit working papers. This clearly does not satisfy the requirements of GAAS.

.21 In considering whether the service auditor's report is satisfactory for his/her purposes, the user auditor should make inquiries concerning the service auditor's professional reputation as discussed in SAS No. 1, section 543, as amended.

.22 The user auditor may want to consider reading the report to determine whether the service auditor demonstrates an understanding of the subject matter. If the user auditor believes that the service auditor's report may not be sufficient to meet his/her objectives, the user auditor may consider supplementing his/her understanding of the service auditor's procedures and conclusions by discussing with the service auditor the scope and results of the service auditor's work.

.23 Also, if necessary, the user auditor may contact the service organization to perform additional testing (this is usually arranged by the user organization). This additional testing can be performed by the service auditor (e.g., by applying agreed-upon procedures at the request of the user auditor) or by the user auditor.

.24 The user auditor should not make reference to the report of the service auditor as a basis, in part, for his/her opinion on the user organization's financial statements. The service auditor's report is used in the audit, but the service auditor is not responsible for examining any portion of the user organization's financial statements as of any date or for any period. Thus, there cannot be a division of responsibility for the audit of the user organization's financial statements.

Timing Considerations in Using the Reports

.25 A service organization's description of controls is as of a specified date for both a Type 1 and Type 2 report. Accordingly, the service auditor issues a report on whether the description presents fairly, in all material respects, the

relevant aspects of the service organization's controls at a specified date. Such information may be used to plan the audit of a user organization's financial statements in the same way that an auditor's understanding of internal controls at a specified date is used to plan the audit of the financial statements of an entity that does not use a service organization.

.26 A report on controls placed in operation that is as of a date outside the reporting period of a user organization may be useful in providing a user auditor with a preliminary understanding of the controls placed in operation at the service organization, if the report is supplemented by additional current information from other sources. If the service organization's description is as of a date that precedes the beginning of the period under audit, the user auditor should consider updating the information in the description to determine whether there have been any changes in the service organization's controls relevant to the processing of the user organization's transactions. Procedures to update the information in a service auditor's report may include:

- Discussions with user organization personnel who would be in a position to know about changes at the service organization.
- A review of current documentation and correspondence issued by the service organization.
- Discussion with service organization personnel or with the service auditor.

If the user auditor determines that there have been significant changes in the service organization's controls, the user auditor should attempt to gain an understanding of the changes and consider the effect of those changes on his/her audit.

Conclusion

.27 SAS No. 70 provides guidance on factors an independent auditor should consider when auditing the financial statements of an entity that uses a service organization. This Alert clarifies and highlights factors an auditor should consider in those audits. SAS No. 70 also provides guidance for independent auditors who issue reports on the processing of transactions by a service organization for use by other auditors, but this Alert does not address those circumstances. This Alert should be read as a complement to SAS No. 70. Terms such as user auditor and service auditor are defined in SAS No. 70.

.28 The AICPA recently issued an updated version of the Auditing Practice Release, *Service Organizations: Applying SAS No. 70*. This publication (AICPA Publication Number 060457-CLD7) provides extensive guidance to auditors performing (1) an audit of a user organization's financial statements and (2) procedures at a service organization that will enable them to issue a service auditors report on a service organization's controls that may affect user organizations. This publication can be purchased by calling (888) 777-7077.

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Section 16,150**Practice Alert 00-1
Accounting for Certain Equity Transactions**

January, 2000

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing professional literature, the professional experience of the members of the Professional Issues Task Force (PITF) and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with the professional literature and that it is only a means of assisting auditors in meeting their professional responsibilities.

.01 Equity or capital transactions are often complex and should involve close scrutiny by auditors. As highlighted at the conclusion of this Alert, substantial additional guidance is available addressing differing forms of equity or capital transactions. In this Alert, the Professional Issues Task Force (PITF) will provide some of the more common examples which require careful consideration to determine the appropriate accounting treatment.

Stock Issued for Goods and Services

.02 Start-up companies commonly issue stock in exchange for property, services, or any other form of asset other than cash. The general rule to be applied when equity instruments are issued to non-employees for property or services other than cash is that the transaction should be recorded at the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable.

.03 An example of the above is as follows:

ABC Manufacturing Inc. purchased inventory from their vendor XYZ & Co. In lieu of cash, ABC issued 1,000 shares of common stock to XYZ. ABC is a closely held company and the value of its stock has no readily determinable market value.

In the above example, ABC should determine the fair value of the inventory they are purchasing and assign that value to the inventory. Assuming the fair value of the inventory was estimated at \$2,500, the accounting entry would be to record inventory at the fair value (\$2,500) with the corresponding credits being recorded to common stock and additional paid-in capital.

.04 Similarly, if ABC issued stock to compensate XYZ for services performed, the services would generally be valued at the estimated fair value of the services, because the services are generally more reliably measurable than the fair value of the securities issued. The manner in which the services are recorded (e.g., capitalize versus expense) will depend on the nature of the services and their treatment under generally accepted accounting principles.

.05 An example of this scenario follows:

Mr. Baylor, a consultant who is not considered a founder or an insider of ABC, performs 1,000 hours of services for 10,000 shares of ABC's common stock. The stock has no readily determinable market value. Mr. Baylor typically charges his clients \$100 an hour.

In this instance the most reliable measurable value would appear to be Mr. Baylor's services valued at 1,000 hours multiplied by \$100 an hour, or \$100,000. Thus, the ABC would record an expense for \$100,000 and credits to common stock and paid-in capital for \$100,000.

.06 In circumstances where the stock issued has no readily determinable market value and the goods and or services received cannot be measured objectively and reliably, a company generally should record the asset or service at a nominal value.

.07 Another example of the above concepts follows:

Mr. Smith, who is not an insider or founder of the company, contributes raw land to a start-up company that will be used to build its manufacturing facility. The land was willed to Mr. Smith 20 years ago and has never been appraised. In exchange for the land, the company issues Mr. Smith 500,000 shares of the company's convertible preferred stock. The company's convertible preferred stock has no active trading, but a valuation was performed by a consultant six months before the land was donated. Mr. Smith is the consultant's uncle. The question is how do you value this transaction.

The above example demonstrates the complexities of equity transactions. First, the valuation of the company's stock by Mr. Smith's nephew would probably not be considered to be a reliable measure due to the fact that they are related parties. If practical, an appraisal of the land by an independent, qualified person may be a reliable measure. However, if an independent, qualified person performed the appraisal of the company's stock, this value may also be a reliable measure. If neither can be reliably measurable, the asset should be recorded at a nominal value.

.08 The use of the book, par, or stated value of the stock as a basis for valuation is not appropriate. Similarly the contractual value assigned to goods, services or other assets received does not represent an appropriate surrogate measure of their value. The company should be able to furnish evidence to outside parties as to how the fair value of the goods, services or other assets was determined, as in the example cited above involving the transaction with Mr. Baylor. In that example, Mr. Baylor kept time records for his consulting services.

.09 Emerging Issues Task Force (EITF) 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*, provides numerous examples of situations where (1) the fair value of the equity instrument is more reliably measurable than the fair value of the goods or services received and (2) the counterparty receives shares of stock, stock options or other equity instruments in settlement of all or a part of a transaction.

.10 EITF 96-18 also addresses the measurement date for accounting for equity instruments that are issued to other than employees in exchange for goods and services. The EITF reached a consensus that the issuer should measure the fair value of the equity instruments using the stock price and other measurement assumptions at the earlier of either of the following:

1. The date at which a commitment for performance by the counterparty to earn the equity instrument is reached (referred to as a "performance commitment"), or
2. The date at which the counterparty's performance is complete.

.11 Examples 1–3 of Exhibit 96-18A of EITF 96-18, describe transactions in which a performance commitment exists prior to the time that the counterparty's performance is complete. Examples 4–7 describe transactions in which a performance commitment does not exist prior to the time the counterparty's performance is complete.

.12 EITF 96-18 is extremely complex. This very brief summary should not be relied upon without a complete reading and understanding of the pronouncement itself. It is mentioned only as a reminder of an important source of authoritative literature on accounting for equity transactions.

Stock Issued to an Owner for Expertise or Intellectual Capital Contributed to Business

.13 Companies sometimes issue stock to an owner for expertise contributed to a business, such as a patent or other intellectual capital. Such circumstances are most common immediately prior to an initial public offering (IPO). The question is what value should the company place on the asset acquired.

.14 The Securities and Exchange Commission (SEC) states in Staff Accounting Bulletin (SAB) Topic 5-G, *Acquisition of Assets from Promoters and Shareholders in Exchange for Common Stock*, that "transfers of nonmonetary assets to a company by its promoters or shareholders in exchange for stock prior to or at the time of the company's initial public offering normally should be recorded at the transferor's historical cost basis determined under generally accepted accounting principles".

.15 The following is an example applying the above principle:

Mr. Norton, a founder of ABC Industries, Inc., contributes a patent to ABC in exchange for stock immediately prior to ABC's IPO. The patent was obtained by Mr. Norton at a cost of \$1,000 (filing fees). The remainder of the costs associated with the patent relate to Mr. Norton's own time developing the intellectual property. If Mr. Norton maintained books in accordance with generally accepted accounting principles, the patent would be recorded on those books at \$1,000. Therefore, when the patent is contributed, ABC should record the patent at \$1,000 with corresponding credits to common stock and additional paid-in capital.

Employee Stock Options

.16 The financial accounting and reporting standards for stock-based employee compensation plans are contained in the Financial Accounting Standards Board's (FASB) Statement No. 123, *Accounting for Stock-Based*

Compensation, and the Accounting Principles Board's (APB) Opinion 25, *Accounting for Stock Issued to Employees*. These pronouncements cover all arrangements by which employees receive shares of stock or other equity instruments of the employer or the employer incurs liabilities to employees in amounts based on the price of the employer's stock. Examples are stock purchase plans, stock options, restricted stock, and stock appreciation rights.

.17 FASB Statement No. 123 prescribes a *fair value method* of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method of accounting for all of their employee stock compensation plans. However, FASB Statement No. 123 also permits an entity to continue to measure compensation cost for those plans using the *intrinsic value method* of accounting prescribed by APB Opinion 25. Where entities elect to continue using the accounting in APB Opinion 25, they are required to make pro forma disclosures of net income and, if presented, earnings per share, as if the fair value method of FASB Statement No. 123 had been applied.

.18 Under the fair value method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Under the intrinsic value-based method, compensation cost is the excess, if any, of the quoted market price of the stock at grant date or other measurement date over the amount an employee must pay to acquire the stock.

.19 The determination of fair value, either for accounting under FASB Statement No. 123 or the pro forma disclosures under APB Opinion 25, can be achieved through use of an option-pricing model (for example, the Black-Scholes or a binomial model) that takes into account, as of the grant date, the exercise price and expected life of the option, the current price of the underlying stock and its expected volatility, expected dividends on the stock, and the risk-free interest rate for the expected term of the option. The discussion of stock option valuation techniques is beyond the scope of this Alert but further guidance is available in FASB Statement No. 123. Also, for some non-public entities with minimal trading information upon which to assess price volatility as required for traditional option valuation techniques, the entity may use a minimum value method. Under the minimum value method, the stock option value is generally considered to equal the current price of the stock reduced by the present value of the expected dividends on the stock, if any, during the option's term minus the present value of the exercise price. For this purpose the present value discount is based on the risk-free rate of return. However, the minimum value could also be computed using the standard option-pricing model and volatility of zero.

.20 It also is important to note that FASB Statement No. 123 requires a fair value method for all equity awards to non-employees, and use of the minimum value method, as described in the preceding paragraph, is not appropriate. This is demonstrated in the above sections of this Alert.

.21 Where options are granted near an IPO, the value at which stock is issued in the IPO should be carefully considered in assessing the market value of options. For such grants, the SEC staff expects the registrant to have objective evidence to support its determination of "fair value." Such objective evidence would include contemporaneous third-party transactions and independent appraisals. "Rule of thumb" discounts, management estimates, related-party transactions (even for cash), and general market data do not represent objective evidence for this purpose. The most objective evidence that

can be used to support the value assigned to stock, options, or warrants is information from a contemporaneous transaction where the value of the consideration received for the company's securities is objectively measurable, i.e., an equity transaction with a third party for cash that is entered into in the same time frame. Absent a contemporaneous transaction, an independent appraisal can form the basis for the valuation. The independent appraisal should have been performed at the time the stock, options, or warrants were issued. Appraisals performed "after the fact" are not acceptable. If the appraised value of the stock is substantially below the IPO price, the company must be able to reconcile the difference between the appraised value and the IPO price, i.e., explain the events or factors that support the difference in values.

.22 In 1999, the FASB issued an exposure draft addressing several issues regarding the accounting for employee stock options and awards under APB Opinion 25. Comments have been submitted and the FASB is re-deliberating many of the conclusions expressed in the exposure draft. A final interpretation of these issues is expected early in 2000. At this time it is expected that practice with respect to many aspects of APB Opinion 25 will be changed as a result of the interpretation.

Retroactive Earnings per Share Adjustment for Cheap Stock

.23 Cheap stock refers to stock issued for nominal consideration (i.e., a price below the price at which stock is subsequently sold in a public issuance of shares) to employees or others closely related to the company. SAB 98 Topic 4-D, *Earnings per Share Computations in an Initial Public Offering*, describes the SEC's position on this issue.

.24 In applying the requirements of FASB Statement No. 128, *Earnings per Share*, the SEC staff believes that nominal issuances are recapitalizations in substance. Accordingly, in computing basic earnings per share (EPS) for the periods covered by income statements included in the registration statement and in subsequent filings with the SEC, nominal issuances of common stock should be reflected in a manner similar to a stock split or stock dividend for which retroactive treatment is required by paragraph 54 of FASB Statement No. 128. Consequently, in computing basic EPS, nominal issuances of common stock would be included for all periods; whereas in computing diluted EPS for such periods, nominal issuances of common stock and potential common stock (e.g., options) would be included for all periods. In addition, use of the treasury stock method is not allowed and retroactive treatment is required even if anti-dilutive.

.25 This retroactive presentation of such nominal issuances as outstanding for all historical periods in the computation of EPS does not alter the requirement that entities determine whether the recognition of compensation expense for any issuance of equity instruments to employees is necessary.

.26 Guidance has not been provided on what constitutes "nominal consideration." SAB Topic 4-D states that it should be determined based upon facts and circumstances by a comparison of the "consideration an entity receives" to the security's fair value (at the date of the issuance).

Extinguishment of Related Party Debt

.27 The AICPA frequently receives questions about whether an entity should record an expense or a charge to equity when a company forgives a receivable from an individual that is a related party of the company. Typically in such situations, the company should record a charge to equity. As a reminder, it should be noted that in certain circumstances, such receivables from related parties often are recorded as a reduction in equity rather than as an asset. This is sometimes required, depending on the nature of the receivable, by the SEC (see SAB Topic 4-E, *Receivables from Sale of Stock*, and Topic 4-G, *Notes and Other Receivables from Affiliates*) and by EITF 85-1, *Classifying Notes Received for Capital Stock*.

.28 Similar to a company forgiving a loan from a related party, sometimes a company's outstanding loan is forgiven by a related party. Such a forgiveness usually should be recorded as a credit to equity. (APB Opinion 26, *Early Extinguishment of Debt*, paragraph 20 states "that extinguishment transactions between related parties may be in essence capital transactions".)

Other Accounting Literature Addressing Equity Transactions

.29 When auditing and accounting for equity transactions, members should review the FASB *Current Text* and the EITF index for a more complete list of accounting literature on such transactions. There are more than 50 accounting pronouncements addressing various equity transactions, including numerous EITFs on the subject. This is indicative of and exemplifies the careful research that is necessary when dealing with equity transactions.

.30 Furthermore, members should review the SEC's SAB Topics when auditing public companies. Several SAB Topics covering equity transactions have been referred to in this Alert.

Summary

.31 Accounting for equity transactions is complex and requires comprehensive research of accounting literature to ensure the appropriate accounting treatment. The above examples provide a summary of the appropriate accounting for certain equity transactions.

[The next page is 50,941.]

Section 16,160**Practice Alert 00-2**
Quality of Accounting Principles—Guidance
for Discussions With Audit Committees

April, 2000

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing professional literature, the professional experience of the members of the Professional Issues Task Force (PITF) and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with professional literature and that it is only a means of assisting auditors in meeting their professional responsibilities.

.01 This Practice Alert is intended to provide auditors with information that will assist them in preparing for and participating in discussions with audit committees. In December 1999, in response to Recommendation No. 8 of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (BRC), the Auditing Standards Board (ASB) issued Statement on Auditing Standards (SAS) No. 90, *Audit Committee Communications*, that amended SAS No. 61, *Communications With Audit Committees*, to require the independent auditor of an SEC client to discuss with a client's audit committee the quality, not just acceptability, of the entity's accounting principles. The BRC was formed in response to recommendations by SEC Chairman Arthur Levitt. The BRC published its final report in Feb. 1999. The report identifies its objectives as being "geared toward effecting pragmatic, progressive changes in the functions and expectations placed on corporate boards, audit committees, senior and financial management, the internal auditor, and the outside auditors regarding financial reporting and the oversight process". The BRC Report includes 10 recommendations to promote those "pragmatic, progressive changes," including Recommendation No. 8, which reads as follows:

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

As mentioned above, in response to Recommendation No. 8, in Dec. 1999 the ASB amended SAS No. 61 to require additional communications with audit committees of SEC clients. This amendment adopted a modified form of Recommendation No. 8 requiring that the independent auditor discuss with the audit committee the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. SAS No. 61, as amended, specifies that the discussion should involve management and include such matters as the consistency, clarity and completeness of accounting policies and disclosures.

.02 The information in this Practice Alert was developed to assist firms in the identification of matters that may be relevant to a discussion with an entity's audit committee of the quality of accounting principles used in the preparation of an entity's financial statements.

.03 The following discussion is in the context of communications between the auditor and the audit committee and/or board of directors. Discussions with the audit committee and/or board generally would include management because management prepares the financial statements and is most familiar with the transactions and environment in which the entity operates.

Auditing Standards Board Action and Objective of Recommendation No. 8

.04 The PITF believes that the objective of Recommendation No. 8 is to educate and advise audit committee members so they may better carry out their oversight role on behalf of the board of directors and ultimately public shareholders. This objective becomes more critical and sensitive in light of increasing expectations of the financial community with respect to audit committees.

.05 The audit committee members benefit from the auditor's views regarding the quality of the entity's accounting principles as applied in its financial reporting. At the same time, management must be regarded as a critical participant in that discussion. The intimate knowledge of management concerning the day-to-day as well as non-recurring matters that influence the operations and financial reporting is essential to an understanding of the financial information. To meet the objectives of the amendments to SAS No. 61, the PITF recommends the following:

- **Manner of Communications.** Communications should be understandable to all members of the audit committee.
- **Timeliness of Communications.** Discussions with the audit committee should be sufficiently frequent to ensure that audit committee members are advised of issues on a timely basis.
- **Relevance of Issues Discussed.** Periodic communications with the audit committee need not encompass all accounting principles, estimates and judgments. Rather, the communications could build on prior communications and address those accounting principles and unusual transactions that are more significant in any particular period's financial statements. For example, an asset impairment policy might be discussed in greater detail in periods in which impairment charges are under consideration, including periods in which impairment charges were considered but determined not to be needed.

.06 Following is a discussion of how management and the auditor may implement the three core communication considerations described above.

1. Manner of Communications

Management and the auditor should tailor communications with the audit committee to the professional and educational backgrounds of the committee members. Management and the auditor can enhance the accounting and financial literacy of the audit committee members by providing presentations on accounting issues, professional publications and financial press articles that will help the members understand critical and significant accounting and financial reporting issues.

2. Timeliness of Communications

Timely communication is inherently dependent upon management, the audit committee, and the independent auditor sharing a common understanding of the timetable and key milestones in the financial reporting continuum. The auditor should attempt to complete the quarterly reviews and annual audit procedures in sufficient time to provide for discussion of significant matters as required by SAS No. 61 with the audit committee on a timely basis and not later than the filing of the entity's Form 10-Q or Form 10-K. The recently adopted SEC requirement for timely review of quarterly financial information is intended to provide greater assurance that accounting and financial reporting issues are identified and resolved timely.

3. Relevance of Issues Discussed

Topics that management and the auditor should consider discussing with the audit committee would include but not be limited to the following:

1. **The accounting principles applied by the entity for which acceptable alternative principles are available.** The manner in which each significant alternative accounting principle would affect the transparency, understandability and usefulness of the financial information could be discussed. The discussion could include identification of the financial statement amounts that are affected by the choice of principles as well as information concerning accounting principles used by peer group companies.
2. **Judgments and estimates that affect the financial statements.** The discussion with the audit committee may include major items for which reserves and estimates are significant, including how such reserves and estimates are determined and subsequently monitored. Generally a discussion of judgments and estimates would cover the appropriate disposition of previously established reserves when the events that caused their creation are no longer applicable. To the extent that judgments and estimates involve a range of possible outcomes, the discussion could indicate how the recorded estimate relates to the range and how various selections within the range would affect the financial reporting. In particular, if the entity has significant

contingencies for which no reserves or minimum reserves are provided, the discussion might consider the current and future financial statement impact of management's decisions. If the enterprise has reserves that are "slow moving" in terms of resolution of the matters to which the reserves relate (e.g., litigation or environmental reserves), management and the auditor might address the continued need for the reserves as well as the impact of changes in the reserves and the balance of the reserves on the perception of the enterprise's financial condition and performance. The adequacy of the disclosures of such contingencies, including the exposure to losses in excess of any recorded amounts, could also be discussed.

3. **Consideration of factors affecting asset and liability carrying values.** Management and the auditor could discuss factors including, but not limited to (a) the company's bases for determining useful lives assigned to tangible and intangible assets and salvage values, (b) discount rates used to value pension and post-retirement obligations, and (c) the carrying value of other assets and liabilities. The discussion should include the type and quality of evidence supportive of such factors. The discussion also might include an explanation of the manner in which factors affecting carrying values were selected and how alternative selections would have affected the financial condition and earnings of the enterprise. The audit committee generally should be made aware of the effect such judgments have on the financial statements.
4. **Use of special structures and timing of actions that affect financial statements.** Examples of special structures or timing decisions would include off balance sheet financing, research and development activities, and timing of transactions in order to recognize revenues or avoid recognition of expenses. Any special purpose financing structures or unusual transactions that affect ownership rights (such as leveraged recapitalizations, joint ventures, and preferred stock of subsidiaries) might be discussed with the audit committee. The discussion could include information about comparative structures used in practice and insight regarding the impact of these special structures on the risks and rewards of the entity and the timing and amounts of reported income and cash flow. The discussion also could address the impact of such structures on the transparency and understandability of the enterprise's economic position as compared to its financial statements.
5. **Evolving issues and choices that affect financial reporting.** Examples of issues and choices affecting financial reporting would include revenue recognition practices such as "gross versus net presentation" or "upfront recognition," outsourcing employee services, tax planning strategies, lease versus buy decisions, use of "restructuring plans," and classification of investments as held-to-maturity versus available-for-sale versus trading. The discussion should address not only the issues and choices but a comparison of how such choices affect financial reporting as compared to effects that would have resulted from other available choices.

- 6. The frequency and significance of transactions with related parties particularly those that are not in the ordinary course of business.** Examples of these kinds of related party transactions include compensation arrangements, loans, related party leases, use of corporate assets, or employment of close relatives. The discussion could address such matters as whether the enterprise had similar transactions at similar prices with unrelated parties, whether transactions were undertaken on a best available price basis, and whether the transactions or pricing of the transactions impacted financial reporting in any significant manner that would not be obvious to a user of the financial statements. Management and the auditor could consider informing the audit committee of the financial statement impact and disclosures of these items, as well as how such transactions reflect the underlying economics. The discussion might also address the adequacy and clarity of the disclosure of related party transactions.
- 7. Unusual arrangements.** Examples of unusual arrangements would include bill-and-hold transactions, self-insurance, multi-element arrangements contemporaneously negotiated, and sales of assets or licensing arrangements with continuing involvement by the enterprise. Such arrangements could be brought to the attention of the audit committee members to ensure that they understand how the business and financial reporting is being affected. The discussion could address the manner in which financial reporting was affected by the transactions, the transparency of the financial reporting and disclosures, and the impact of the unusual transactions on the comparability of financial condition and performance among past and future periods.
- 8. Clarity and Transparency.** Management and the auditor could discuss the clarity and transparency of the financial statements and disclosures. Examples of items to discuss would include details about restructuring activities, activity in reserve accounts, market risk and other risk disclosures, details and comparative data discussed in management's discussion and analysis, disclosure of alternative measures of performance whether in financial statements or other materials filed with the SEC or otherwise publicly distributed, and segment disclosures.
- 9. Audit adjustments identified in the audit.** The discussion should address adjustments recommended by the auditor whether or not recorded by management that, in the opinion of the auditor, have a significant effect on the entity's financial reporting process. Further, because of the issuance of SAS No. 89, *Audit Adjustments* (another amendment to SAS No. 61), the auditor also must inform the audit committee "about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole." The discussions could also include the qualitative and quantitative bases considered in deciding to record certain proposed audit adjustments. The discussion of

qualitative and quantitative bases could address each significant financial statement measure that was considered in arriving at a decision to record or to not record the proposed adjustments. For adjustments not made, there should be a consideration of how the decision not to record the adjustments affected the period-to-period comparability and the transparency of reported financial condition and results of operations.

- 10. Materiality thresholds and cost/benefit judgments.** The discussion could address the qualitative and quantitative criteria used by management in making its materiality assessments. The discussion could also address the performance measures or other specific factors considered in making materiality judgments. For example, is materiality measured in relation to sales, gross margins, segment margin, specific financial statement lines items, before and after special non-recurring items? The discussion might address how the materiality criteria affect the period to period comparability of reported financial condition and results of operations.

Discussion of Quality, not Acceptability or Preferability, of Accounting Principles and Judgments

.07 Objective criteria have not been developed to aid in the consistent evaluation of an entity's accounting principles as applied in its financial statements. SAS No. 61, as amended, directs the discussion with the audit committee to include items that have a significant impact on whether the financial statements are representationally faithful, verifiable, neutral and consistent. These characteristics can serve as a basis for a discussion of quality in the broadest sense of the word since these are among the desired qualitative characteristics of accounting information as set forth in Financial Accounting Standards Board's Concepts Statement (Concepts Statement) No. 2, *Qualitative Characteristics of Accounting Information*. The appendix [paragraph .13] to this Practice Alert provides an expanded list of qualitative characteristics identified under three models of quality in financial reporting that were considered in developing this Practice Alert.

Discussion of Aggressiveness vs. Conservatism in Financial Reporting

.08 Recommendation No. 8 suggests that the auditor's communication with the audit committee should address the degree of aggressiveness or conservatism of the accounting principles applied in the financial statements. The concept of aggressiveness or conservatism was viewed by many as too ambiguous to be dealt with effectively in response to the BRC recommendation. As a result, the amendment to SAS No. 61 that requires the auditor to discuss quality with the audit committee, as discussed above, addresses the BRC recommendation by requiring a discussion of items that have a significant impact on representational faithfulness, verifiability and neutrality of the accounting information included in the financial statements as those terms are defined in Concepts Statement No. 2. Accordingly, a discussion of aggressiveness vs. conservatism is not required. If, however, either the auditor or the audit committee desire to discuss this concept, the following discussion may be helpful.

.09 Conservatism may be defined as prudent reaction to try to ensure that uncertainty and risks inherent in business situations are adequately considered. The term today is often misunderstood and has sometimes been used to defend accounting judgments that may not be fully supportable. As a result, the crossover between what is conservative and what is aggressive is sometimes difficult to distinguish. In the current financial reporting environment, actions that are conservative to one person may be viewed as aggressive by another. An entity that provides reserves for losses based on an overly pessimistic view (and thus may have excess reserves that can be released into earnings in future periods) may be viewed as aggressive in the current reporting environment notwithstanding past experience of companies being viewed as aggressive for having failed to provide adequate reserves. Providing for losses on a “too-much, too-soon” basis is as erroneous as providing for losses “too-little, too-late”. Conservatism in financial reporting should not be used to justify understatement of income or assets.

.10 Financial statements are useful in making investment and lending decisions when an entity’s accounting principles are applied in a manner that is reasonable in light of all known circumstances. Discussions with the audit committee of the degree of aggressiveness or conservatism in financial reporting may take into account the financial reporting effects of accounting principles on all of the financial statements and all periods presented as well as expected future financial statement effects. For example, the use of inappropriately low salvage values for depreciable assets will result in the understatement of current period assets and income. This will, however, overstate income in future periods as the company benefits from the continued use of fully depreciated operating assets.

.11 Choices among accounting principles and their application involve judgment. Judgments frequently involve the determination of a range of reasonableness. In practice, the terms conservative and aggressive are meant to connote management judgments that are within the range of reasonableness but are on the safe side or on the cutting edge of the range of reasonableness. Any discussions with the audit committee about the aggressiveness or conservatism of accounting principles should address the manner in which a reasonable range is determined and how choices are made and applied within that range.

Summary

.12 Under SAS No. 61 the auditor is required to communicate a number of matters, including the quality of an entity’s accounting principles, with the entity’s audit committee. The purpose of communication with the audit committee is to provide the audit committee with information that may assist it in overseeing the entity’s financial accounting, reporting and disclosure process. The auditor’s attention to the accounting and financial knowledge of audit committee members, the timing of communications, and the delivery of appropriate content in the proper context will enable auditors to provide significant insight and assistance to the audit committee to fulfill its oversight role while observing a high standard of professional practice.

Appendix

Qualitative Characteristics of Financial Reporting

The Financial Accounting Standards Board has identified certain characteristics of accounting information that make it useful for achieving the objectives of financial reporting and guide the selection of accounting principles and policies from among available alternatives. These characteristics include:

Relevance—the capacity of information to make a difference in a decision by helping users to form predictions about the outcomes of past, present and future events or to confirm or correct prior expectations. In determining what is relevant, considerations would include:

- Current trends in the market place;
- Transparency; and
- Clarity

Reliability—the quality of information that assures that information is reasonably free from error and bias and faithfully represents what it purports to represent.

Comparability—the quality of information that enables users to identify similarities in and differences between two sets of economic phenomena.

Consistency—conformity from period to period with unchanging policies and procedures. In addition to the FASB model, there is an academic model of earnings persistence that could be considered. This academic model is based on the perspective of the investors'

- Ability to distinguish core earnings from non-core earnings;
- Ability to segregate peripheral financial items or business results from results that are integral to the ongoing business. This is facilitated by—
 - Identification of the company's core earnings;
 - The SEC's MD&A concept; that is, disclosure of information known today that indicates the relevance or non-relevance of past performance to expected future performance; and
 - Prominent display and disclosure of unusual and non-recurring items.

A third model suggests that preferability and quality are synonyms. In some cases where the accounting literature offers alternatives, the literature specifies which model is preferable. Some believe the preferable principle is always the higher quality principle. In cases where new standards are pending, standards issued but not yet effective generally are viewed as "preferable." Many standards allow for early adoption and are often considered preferable to existing practice. Some view early adoption of a new standard as higher quality reporting. In the absence of specific accounting literature, some view a principle that is analogous to a principle embodied in current literature as preferable or of higher quality.

However, the deficiency in this third model of evaluating quality is that the terms "preferable" and "quality" in fact are not synonymous. A principle need not be preferable in order for it to be a quality principle.

[The next page is 50,961.]

Section 16,170**Practice Alert 00-3
Auditing Construction Contracts**

September, 2000

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing professional literature, the experience of the members of the Professional Issues Task Force (PITF) and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with the professional literature and that it is only a means of assisting auditors in meeting their professional responsibilities.

Introduction

.01 One of the more challenging audits is that of construction companies and other companies using the percentage of completion method of accounting for long-term contracts. This Practice Alert is intended to serve as a reminder of the important concepts, and provide some best practices for auditing such entities.

.02 The primary authoritative accounting literature for construction companies, and entities using contract accounting is SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* [section 10,330]. A thorough understanding of this literature is critical to auditing such entities. The AICPA's guide entitled "A CPA's Guide to Accounting, Auditing and Tax for Construction Contractors" and the related self-study course, are useful tools in preparing for such audits.

.03 Auditing construction contractors or entities using contract accounting is complex. Such businesses rely on accurate and reliable estimates to operate their business as well as to prepare financial statements in accordance with generally accepted accounting principles. Therefore, it is critical that the auditor gain an understanding of the contractor's significant estimates and assumptions in operating its business. Remember that the audit of a contractor is an audit of a contractor's ability to estimate. There are several things to consider when auditing estimates (also see SAS No. 57, *Auditing Accounting Estimates*): Understand the internal control structure surrounding the estimate, consider the contractor's history of accurate estimates, compare actual to budgeted figures, and review subsequent events.

Best Practices

.04 The PITF has identified certain procedures that should be considered in performing an audit of a construction contractor. They are as follows:

- Read significant contracts. This procedure may seem obvious, but it is necessary in identifying the terms of the contract, any guarantees, penalties and incentives, as well as any cancellation and postponement provisions. For instance, reading the contract might identify the party responsible for additional expenses incurred as a result of weather delays (e.g., a colder than normal winter). Make sure the contracts are approved by the appropriate company personnel.
- Identify unique contracts and increase the amount of testing and professional skepticism relating to such contracts. These contracts increase the risk of improper estimates and thus improperly stated financial statements. If a company cannot reasonably estimate the cost or progress of a contract, it should be accounted for under the completed-contract method. For example, if a home building company decides to build power plants, they should consider accounting for such contracts under the completed-contract method until they are reasonably confident that its estimates in the power plant portion of the business are reliable.
- Understand the company's cash flow and how it will manage paying out expenses. Often expenses are due prior to receiving all the appropriate cash for the contract revenue. Some companies win long term contracts, but cannot fund the project long enough to realize the revenue earned. It is not uncommon for a customer to withhold 20%–25% of the contract price until they are satisfied with the quality of the completed contract.
- Recognize that the longer the contract period, the greater the risk that an estimate will be incorrect. Also, the farther along a contract is toward completion, the less risk there is of an incorrect estimate. Finally, the more variables inherent in an estimate the greater the risk that an estimate will be incorrect.
- Confirm the terms and conditions of the contract as well as the normal billing procedures. When confirming a receivable the auditor should strongly consider confirming: the original contract price, total approved change orders, total billings and payments, retainage held and whether it accrues interest, detail of any claims, back charges or disputes, and estimated completion date or the estimate of percentage complete.
- Review the unapproved change orders of significant contracts. Change orders often arise during the life of a contract and estimated revenue and cost should be adjusted for changed orders that have been approved both as to scope and price. However, when a change order has been approved as to scope but not price careful evaluation of the specific facts and circumstances is required prior to inclusion in estimated contract revenues. To the extent that change orders are in dispute or are unapproved in regard to both scope and price they should be evaluated as claims. Generally speaking, if there is no verifiable evidence to support the recognition of revenue on an unapproved change order or claim, it should not be recognized.
- Visit construction contract sites. Visiting contract sites can be a very useful audit procedure. Such a visit can provide an opportunity to view

the progress of a contract. Consideration of a site visit might include significant contract sites, in which the work is in the very early stages of a contract. Such a visit may identify the complexities of performing the contract. For example, a contract being performed in remote regions of Alaska presents certain logistical risks that may not be appreciated or understood without visiting. The site visit also may provide auditors an opportunity to interview operational personnel and to gain a better understanding for the responsibility the Company is undertaking performing the contract. At the site visit an auditor should also speak with available subcontractors on site to get additional information about the progress of the engagement. Furthermore, the auditor should consider observing equipment and uninstalled inventory on site.

- Meet with project managers. Project managers play an important role in controlling and reporting job site costs. They are also close to the facts and are likely to get more prompt and accurate information than the accounting personnel. For example, a project manager may be aware of a large bill that will arrive relating to his or her project about which the accounting department has not yet been notified. Meeting with the project managers will also assist the auditor in developing expectations for use in performing analytical review procedures. Also, consider having the project managers of significant contracts complete a questionnaire regarding the status of their contracts.
- Identify and understand the significant assumptions and uncertainties. This procedure is fundamental to performing an effective audit of an entity using contract accounting. Not performing this function results in an audit that does not comply with GAAS.
- Test contract costs to make sure that costs are matched with appropriate contracts. In some instances a company may shift costs from unprofitable contracts to profitable ones in an effort to defer losses.
- Audit estimated costs to complete. The focus should be on the key factors and assumptions, such as those that are (a) significant to the estimate, (b) sensitive to variation, (c) deviate from historical patterns, and are (d) subjective and susceptible to bias or misstatement. A review of revised or updated estimates of cost to complete and a comparison of the estimates with the actual costs incurred after the balance sheet date is also a useful procedure.
- See that losses are recorded as incurred, regardless of whether an entity is using the percentage-of-completion or the completed-contract method of recognizing revenue.
- Analytically review contracts completed and in progress. A detailed analytical review of completed contracts and contracts in progress will provide meaningful information in helping to focus the auditor's efforts on potential problem areas. The look back analysis also reveals significant information about the company's ability to estimate.
- See that there are appropriate disclosures relating to SOP 94-6, *Disclosure of Risks and Uncertainties* [section 10,640]. Entities using contract accounting probably should have more than generic disclosure about the use of significant estimates used in the preparation of financial statements. The AICPA SEC Practice Section has noticed that many companies include excellent disclosure about the risk of

contract losses and the possibility of inaccurate estimates in the forefront of their Form 10-K. It is the PITF's view that some of that enhanced disclosure would strengthen financial statement disclosure.

- Review the aging of receivables on contracts. This procedure will provide evidence that a Company is collecting funds on a timely basis.
- Consider the use of specialists in auditing construction contracts in accordance with SAS No.73, *Using the Work of a Specialist*.

.05 Auditing entities that use contract accounting is challenging in that the main element of the contractor's financial statements are based on estimates of cost, and, importantly, costs not shipments drive the revenue recognition process.

.06 Prior to auditing contractors an auditor should ensure that they have the appropriate expertise to understand the risks of the business. This additional knowledge will lead to an audit that meets or exceeds generally accepted auditing standards.

[The next page is 50,981.]

Section 16,180

Practice Alert 00-4 Quarterly Review Procedures for Public Companies

October, 2000

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their quarterly reviews and is based on existing professional literature, the experience of the members of the Professional Issues Task Force (PITF) and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with the professional literature and that it is only a means of assisting auditors in meeting their professional responsibilities.

Introduction

.01 In December 1999, the Securities and Exchange Commission (SEC) adopted a rule that requires a company's independent auditor to review the company's interim financial information prior to the company filing its quarterly report on Form 10-Q or Form 10-QSB. In the SEC staff's view, this rule makes it a clear violation of the securities laws for a company to file such a quarterly report without having its auditor perform the review in advance of the filing. The rule was effective for all fiscal quarters ending on or after March 15, 2000. For further information, see the release entitled "Audit Committee Disclosure" at the SEC's Web site: www.sec.gov/rules/final/34-42266.htm. Because the SEC release also includes other new requirements not discussed in this Practice Alert, the PITF recommends that all auditors of SEC registrants review this release.

.02 The professional standards and guidance for conducting interim reviews are set forth in Statement on Auditing Standards No. 71, *Interim Financial Information*. The objective of a review of interim financial information is to provide the auditor with a basis for reporting whether material modifications should be made for that information to conform with generally accepted accounting principles. The auditor's assessment should be based on objectively applying the auditor's knowledge of financial reporting practices to significant accounting matters of which the auditor has become aware through inquiries and analytical review procedures. When the auditor has not audited the most recent annual financial statements, the auditor should perform sufficient procedures to obtain an adequate knowledge of the entity's internal

control structure and procedures in order to performed an effective quarterly review.

.03 The procedures for conducting a review of interim financial information should include:

- Inquiries concerning internal controls, especially changes in internal control since the most recent financial statement audit or review;
- Analytical review procedures over interim financial information;
- Reading the minutes of meetings of stockholders, the board of directors, and appropriate committees;
- Reading the interim financial information for conformity with generally accepted accounting principles;
- Inquiries of officers, executives, and other appropriate personnel;
- Obtaining written representations from management concerning its responsibility for the financial information, completeness of minutes, subsequent events, and other relevant matters;
- Obtaining reports from other auditors, if any, who have reviewed the interim financial information of significant components of the reporting entity.

.04 All of the above procedures should be performed with consideration as to their impact on the preparation and presentation of interim financial information.

Suggested Procedures

.05 The PITF has identified certain other procedures that should be considered in performing quarterly reviews. They are as follows (the auditor may want to consider developing a checklist of procedures):

- Read the Form 10-Q or 10-QSB, including management's discussion and analysis, to determine that such information is consistent with the interim financial statements (similar to a review under SAS No. 8 *Other Information in Documents Containing Audited Financial Statements*) and other information of which the auditor is aware. The auditor should consider reviewing all financial information in press releases and other documents filed with the SEC or other regulators. The company's Web site, the SEC's Web site, and other Internet sites are good sources for reviewing such information.
- Review and understand any restructuring charges taken in the current and prior quarters. Appropriate accounting guidance, e.g., EITF Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*, and SEC Staff Accounting Bulletin No. 100, *Restructuring and Impairment Charges*, should be considered when such charges are recorded.
- Review and understand any current or prior quarter extraordinary items.
- Consider tracing and agreeing financial statement amounts to the company's general ledger and other appropriate accounting records. For companies with simpler account structures, this is an easy way of

avoiding classification or other errors. For companies with complicated account structures, this may be more difficult. In such instances, the auditor should consider the company's internal controls over accumulating and consolidating information, and the frequency of errors encountered during the annual audit, when performing these procedures. Additionally, all financial information should be independently recalculated and cross-referenced.

- Consider fraud risk factors. Inquire of management as to their understanding of the risk of fraud in the company and whether they have any knowledge of fraud that has been committed.
- Review the company's revenue recognition methods and determine compliance with generally accepted accounting principles. Additionally, the auditor may want to consider having the company's management confirm the absence of side agreements.
- Perform appropriate analytical review procedures. Analytical review procedures provide a basis for inquiries regarding significant account balances and are, therefore, an integral part of the quarterly review. Analytical review procedures might include:
 - Comparison of the financial information to the previous period and corresponding prior periods;
 - Comparison of ratios and indicators developed from recorded amounts to expectations based on prior periods and industry averages. Examples of key ratios and indicators include: current ratio, receivable turnover or days sales outstanding, inventory turnover, depreciation to average fixed assets, debt to equity ratio, gross profit percentage and net income percentage;
 - Comparison of financial information to budgets and forecasts;
 - Comparison of financial information to that of others in the same industry;
 - Vertical analysis of financial information in comparison to prior periods. Examples of vertical analysis include expenses by type as a percentage of sales, and assets by type as a percentage of total assets;
 - Gross profit analysis by product line and business segment;
 - Recalculating amortization of significant intangible assets;
 - Analyze income tax balances. These procedures should include relating the provision for income taxes to pre-tax income, and relating current and deferred tax accounts to budgets and prior periods. Inquiries should be made regarding unusual rates and balances.

Significant account fluctuations that should be reviewed with additional emphasis include:

- Business combinations;
- Disposal of a segment of a business;
- Extraordinary, unusual, or infrequently occurring transactions;
- Litigation or the development of other contingencies;
- Changes in major contracts with customers or suppliers;
- Changes in accounting principles or the methods of applying them;
- Trends and developments affecting accounting estimates, such as allowances for bad debts and excess/obsolete inventories, warranty provisions, and unearned income.

.06

- Consider reviewing non-standard journal entries. Standard journal entries include those journal entries processed in the normal course of business, such as sales, inventory purchases and cash disbursements. Standard journal entries are normally subject to the company's internal controls. Non-standard journal entries are those that are made outside the normal course of business, and might be made outside the company's internal control structure, such as the provision for bad debts, the provision for inventory obsolescence, and cut-off or period-end adjustments. Non-standard journal entries may pose increased risk to the auditor in that they might represent attempts by management to manage earnings and could be recorded in any general ledger account.
- Review and recalculate the company's earnings per share (EPS). The calculation should be compared with recent EPS calculations for consistency. Consideration also should be given to the effects of interim developments, such as the issuance of stock and granting of options. Such items may be found by reading minutes of meetings of the board of directors and the compensation committee.
- Inquire about compliance with debt covenants. If key financial requirements have been close to default level in the past, or there have been significant changes in relevant account balances, a review of the company's debt covenant calculations should be performed. If the calculations have not been performed at the end of each quarter, the auditor should consider insisting that the company require that such calculations be performed.
- Follow-up on material contingencies from prior audits and reviews. For example, when an auditor is informed during the annual audit that a significant account will be collected the next month, follow-up during the first quarter review would be appropriate.
- Consider reviewing details of significant transactions occurring in the last several days of the quarter.

Other Matters for Consideration

Issuance of Review Reports

.07 In practice, a review report typically is not issued on interim financial information, although SAS No. 71 provides that a report may be issued. The SEC does not require, and most companies do not request, the issuance of a review report. However, the SEC does require that if a company includes a representation in their filing that the auditor has performed a timely review, the auditor's report on the review must accompany the interim financial information. When a review cannot be completed within the 45-day SEC filing deadline, the auditor should suggest that the company delay the filing until the review is complete. SEC Form 12b-25, *Notification of Late Filing*, properly submitted to the SEC within one calendar day of the prescribed due date will extend the due date by five calendar days. Further extensions are not available. The SEC staff does not consider a Form 10-Q that is filed prior to the completion of the auditor's review to be timely filed or a complete document filing.

Concurring Partner Review

.08 There is no requirement of either the SEC or the AICPA's SEC Practice Section for a concurring partner review when performing a review of interim financial information. Firms providing information to the PITF have indicated varying degrees of concurring partner review requirements, some requiring it and some not. However, significant judgmental matters should warrant consultation with the concurring review partner.

Coordinating the Review with the Annual Audit

.09 The cost of conducting a review of interim financial information is a consideration for both the company and the auditor. However, if the review is properly planned and executed, it can assist and strengthen the annual audit. The quarterly review procedures should be tailored to take into consideration, among other things, the nature of the company's business and internal control structure. Some of the procedures performed during a quarterly review also might be necessary as part of the annual audit. Audit planning should partially evolve from the results of the quarterly reviews. Further, a review does not preclude the use of audit procedures.

.10 For example, if a company has a well-controlled means of processing a high volume of transactions, the auditor may choose an audit strategy that is control reliant. Inquiries regarding changes in the control environment would be particularly important during a review of interim financial information. In addition to these procedures, some of the tests of the control system can be performed as part of the quarterly review. This provides added support that the control system is functioning properly and may reduce the amount of testing required during the year-end portion of the annual audit.

.11 If a company uses the percentage-of-completion method of accounting for long-term contracts, a review of significant contracts and related discussions regarding estimates to complete with appropriate company personnel could be performed during the quarterly review. This should reduce the amount of time needed to review contracts at year-end and could alleviate potentially embarrassing and costly revenue recognition issues from surfacing at year-end. In addition, if a company had a significant business combination or restructuring, the auditor may want to perform audit procedures at a quarter-end to help streamline the year-end audit.

.12 Auditors are reminded that APB No. 28, *Interim Financial Reporting*, requires disclosure of significant fourth quarter items and adjustments in a note to the annual financial statements.

Communication with Audit Committees

.13 SAS No. 90, *Audit Committee Communications*, clarifies that the accountant performing the quarterly review should communicate to the audit committee or be satisfied, through discussions with the audit committee, that matters described in SAS No. 61, *Communication With Audit Committees*, have been communicated to the audit committee by management when they have been identified in the conduct of interim financial reporting. For instance, the accountant should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates or about a change in a significant accounting policy affecting interim financial information. SAS No. 90 further requires the accountant of an SEC client to attempt to discuss with the audit committee the matters described in SAS No. 61 prior to the filing of the Form 10-Q or 10-QSB. When

the auditor becomes aware of a probable misstatement due to a departure from GAAP, he or she should discuss the matters with the appropriate level of management as soon as possible. If management fails to appropriately respond in a reasonable period of time, the auditor should inform the audit committee or equivalent as soon as practicable. This communication may be oral or written and should be documented in the working papers. If the audit committee fails to appropriately respond in a reasonable period of time, the auditor should consider whether to resign from the review and the audit.¹ In such circumstances, the auditor should consider consulting with his or her attorney to, among other reasons, determine if he or she has any responsibility to report fraud under Section 10A of the Securities Exchange Act of 1934.

Timing

.14 As previously mentioned, the new SEC rule requires that a company's auditor review the financial information included in the company's Form 10-Q or 10-QSB prior to the company's filing with the SEC. Many of the required review procedures can be performed prior to or simultaneously with the company's preparation of the quarterly financial statements. For example, it may be practical to begin reading applicable minutes and update the understanding of the company's internal control environment prior to the end of an interim period. Also, certain basic analytical procedures and inquiries may be completed prior to the end of the period (e.g., as of the end of the second month of a quarter) if the company has strong internal controls. The auditor also should, if at all possible, schedule the same personnel to the quarterly reviews who have been and will be assigned to the annual audit.

.15 Some companies will want to issue their press release prior to the completion of the review. Under these circumstances, the auditor should attempt to perform as much of the review as possible, prior to the release of earnings. Nonetheless, the auditor should not be publicly associated with the press release.

Summary

.16 For all fiscal quarters ending on or after March 15, 2000, the SEC requires that the interim financial information included in a company's Form 10-Q or Form 10-QSB be reviewed by the company's independent auditor prior to being filed. A company that files its quarterly report without having its auditor perform a quarterly review is, in the SEC staff's view, in violation of the securities laws, and an auditor with a client who does this should consider discussing the matter with the company's audit committee and the company's legal counsel. Guidance for conducting such reviews can be found in the SAS No. 71.

.17 One of the primary reasons the SEC has mandated the above requirement is to minimize large year-end adjustments to quarterly financial statements that historically have been uncovered in the annual audit process. The PITF believes the suggested procedures listed in this Practice Alert will assist in the timely identification of material accounting issues, and they should reduce the likelihood of quarterly restatements.

[The next page is 50,991.]

¹ Auditors are reminded of their responsibilities for disclosure to audit committees under SAS No. 82, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 54, *Illegal Acts by Clients*.

Section 16,190

Practice Alert 01-1 Common Peer Review Recommendations

April, 2001

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing professional literature, the experience of the members of the Professional Issues Task Force (PITF) and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with the professional literature and that it is only a means of assisting auditors in meeting their professional responsibilities.

Introduction

.01 The PITF believes that a summary of common peer review findings will be helpful to professionals as they consider critical and significant issues in planning and performing audits. The PITF hopes that by highlighting these items, the quality of audits will be enhanced and compliance with generally accepted auditing standards will be increased. Furthermore, the PITF hopes this alert will increase the sensitivity to these issues by professionals conducting peer reviews.

.02 Based on AICPA statistics of more than 21,000 peer reviews over the last four years, the PITF noted that approximately 94% of the peer review reports issued resulted in an unmodified report on the firm's quality control system. Approximately 5% resulted in modified reports and less than 1% resulted in adverse reports on the firm's quality control system. Overall, peer review results have improved since the inception of the peer review program.

.03 The most common peer review recommendations can be grouped into five categories: 1) implementation of new professional standards or pronouncements, 2) application of generally accepted accounting principles (GAAP) pertaining to equity transactions, 3) application of GAAP pertaining to revenue recognition considerations, 4) documenting audit procedures or audit findings, and 5) miscellaneous findings.

Implementation of New Professional Standards or Pronouncements

.04 Peer reviewers have noted that some firms have not implemented new professional standards and pronouncements on a timely basis. The most recent common examples of professional standards that these firms failed to implement

on a timely basis include the application of Independence Standards Board (ISB) No. 1, *Independence Discussion with Audit Committees* and SAS No. 85, *Management Representations*. ISB No. 1 requires a firm to disclose certain relationships and confirm its independence in writing with each of its SEC audit clients every year. Details about the ISB and ISB No. 1 can be found on the ISB Web site at www.cpaindependence.org. Also, Practice Alert 99-1, *Guidance for Independence Discussion with Audit Committees* [section 16,130], provides examples of ISB No. 1 letters. SAS No. 85 states that written representations from management should relate to all financial statement periods covered by the auditor's report. For example, if a firm is giving an opinion on the financial statements at and for the years ended December 31, 2000 and 1999, a representation letter should be obtained that includes representations for 1999 and 2000. These representations should be updated each year even if they were obtained in the previous year, such as 1999 in the previous example.

.05 There are frequently more than a dozen new pieces of authoritative professional literature issued each year. The most authoritative sources of new professional literature are issued by the Auditing Standard Board of the AICPA ("ASB"), the Financial Accounting Standards Board ("FASB"), and the SEC in the form of Staff Accounting Bulletins ("SAB's"). However, other authoritative literature is issued in the form of Statements of Position ("SOP") issued by the Accounting Standards Executive Committee of the AICPA ("AcSEC"), consensus positions of the Emerging Issues Task Force ("EITF") and standards and interpretations issued by the Independence Standards Board ("ISB") and the Governmental Accounting Standards Board ("GASB"). Other professional guidance that should be considered includes the AICPA Accounting General and Industry Audit Guides and related Risk Alerts.

.06 A firm's quality control system should be designed to provide reasonable assurance that its professionals are informed of changes to the professional literature. To assist a firm in achieving this objective, a professional may be designated to help ensure that the new pronouncements are understood and implemented in a timely fashion. Many firms rely on third-party practice aids to help them in this endeavor. This is most effective if the material is updated frequently and the firm's professionals are informed of the changes and how the changes might affect their specific client engagements. The PITF recommends that even when using third-party practice aids, each firm should assign an experienced professional who is responsible for helping to ensure new pronouncements are implemented in a timely manner.

Equity Transactions

.07 Accounting for equity transactions can be complicated and some professionals do not encounter many of these transactions very frequently. Consequently, in January 2000, the PITF issued Practice Alert 00-1, *Accounting for Certain Equity Transactions* [section 16,150]. This Alert provided some of the more common examples, which require careful consideration in determining the appropriate accounting treatment. Common examples where GAAP has been misapplied include (1) stock issued for goods and services, (2) the issuance of warrants, (3) conversion features, and (4) stock options plans. The PITF strongly encourages consultation with other qualified professionals when auditing these transactions. Accounting for many equity transactions may be complicated and therefore, this engagement area may need to be assessed as moderate to high-risk.

Revenue Recognition

.08 Accounting for revenue continues to be an area of focus at the SEC. Specifically, in December of 1999, the SEC issued SAB 101, *Revenue Recognition*, in an attempt to clarify guidance on when it is appropriate for companies to recognize revenue. In October 2000, the SEC also published answers to frequently asked questions ("FAQ's") on SAB 101 which is available at www.SEC.gov/info/accountants.shtml. In November 1998, the PITF issued Practice Alert 98-3, *Revenue Recognition Issues* [section 16,120]. That Alert is intended to remind auditors of certain factors or conditions that can be indicative of increased audit risk relative to improper, aggressive or unusual revenue recognition practices and suggests ways in which auditors may reduce the risk of failing to detect such practices. Additionally, the AICPA's revenue toolkit is available electronically at www.aicpa.org/members/div/auditstd/pubaud.htm. Loading the toolkit from this Web site requires the use of the software Acrobat Reader. The toolkit can also be purchased from the AICPA at 888/777-7077 by requesting product number 022506. Finally, SOP 97-2, *Software Revenue Recognition* [section 10,700], is an important resource for software companies, whether auditing or accounting for revenue.

Documentation

.09 SAS No. 41, *Working Papers*, is the authoritative literature that provides guidance for documentation requirements. Other SASs (e.g., SAS Nos. 55, 61, and 82) also contain specific documentation requirements. The PITF members and the SECPS Peer Review Committee have noted that documentation in the following areas could be improved:

- Fraud risk factors, the disposition of such identified factors, or the planned procedures to address these risk factors.
- The firm's understanding of the internal control system and the basis for reliance on that system.
- Materiality considerations including those relating to waived audit adjustments.
- The extent of auditing procedures performed, the person(s) performing specific procedures, and the conclusion reached.
- Analytical procedures used in planning the nature, timing and extent of the other auditing procedures to be performed; as substantive procedures to audit account balances, classes-of-transactions or assertions; and in the overall review of the financial information during the final stage of the audit.
- Compliance with loan covenants, or whether the company had obtained formal waiver letters from lenders that, when necessary, cover at least a year from the balance sheet date.
- The consideration of going concern and, if necessary, management's plan to keep the entity operating.
- Consultation on significant matters.
- The extent of competent evidential matter supporting significant estimates.

- The completion of an accounting disclosure checklist when required by the firm's quality control policies and procedures. This document, when prepared correctly leads to complete financial statement disclosures complying with GAAP. Some of the more common deficiencies are incomplete disclosures related to deferred income taxes, the use of estimates and advertising policies and costs.
- The performance of appropriate quarterly review procedures. The PITF issued Practice Alert 00-4, *Quarterly Review Procedures for Public Companies* [section 16,180], in October 2000. This Alert provides auditors with the required quarterly review procedures and suggested procedures that should be considered when performing a quarterly review for a public company.
- Documenting SAS No. 61, *Communication With Audit Committees*, and SAS No. 90, *Audit Committee Communications*. If this communication is not in writing, it must be documented in the working papers as to what, when and with whom the communications occurred.

Miscellaneous

.10 Peer reviewers have also noted deficiencies in the following areas:

- Performing ongoing monitoring procedures or a timely annual inspection. A firm's monitoring procedures or annual inspection needs to be completed timely so that the results and recommendations can be communicated and implemented prior to the firm's next busy season. A firm may elect to have the external peer review substitute for the internal inspection in the year an external peer review is performed.
- Performing an appropriate concurring partner review on an SEC attest engagement. Firms that are members of the SECPS are required to have a concurring review performed by a qualified partner of the firm or another firm. The concurring review partner should not be associated with the performance of the engagement. A partner, as defined by the SECPS, is an individual who is legally a partner, owner or shareholder in a CPA firm or a sole practitioner and should be party to any partnership, ownership or shareholder agreement of the firm.

.11 A concurring partner reviewer's responsibility as documented in the SECPS membership requirement (www.aicpa.org/members/div/secps/coparemere.htm) is fulfilled by performing the following procedures: 1) discussing significant accounting, auditing and financial reporting matters with the audit engagement partner; 2) discussing the audit engagement team's identification and audit of high-risk transactions and account balances; 3) reviewing documentation of the resolution of significant accounting, auditing and financial reporting matters, including documentation of consultation with firm personnel or resources external to the firm's organization (such as standard-setters, regulators, other accounting firms, the AICPA, and state societies); 4) reviewing a summary of unadjusted audit differences 5) reading the financial statements and auditors' report; and 6) confirming with the audit engagement partner that there are no significant unresolved matters. Engagement files should contain evidence that the concurring partner review was performed timely and that SECPS membership requirements were met. Typically, a concurring review takes longer than a couple of hours and may take many hours on larger engagements.

- Obtaining verification of independence when a firm uses per diem and contract employees, or outside concurring reviewers. Such independence is necessary to comply with professional standards.
- Compliance with the SEC rules on performing bookkeeping services for public companies. Instances were noted where firms were maintaining the client's fixed assets records and preparing and computing fixed asset depreciation schedules for audit clients. The SEC prohibits an auditor from performing such services because they believe it impairs auditor independence. The SECPS has also noted instances where the auditor was assisting their SEC client in closing out their books, including preparing routine accruals. This activity would appear to impair independence.
- Meeting the auditor's responsibilities with respect to performing and documenting subsequent event procedures in connection with the re-issuance of opinions or the issuance of consents. A firm is required to update discussions with management and attorneys, and obtain a formal written management representation letter up to the filing or effective date, or as close thereto as reasonable and practicable.

Annual Reviewers' Alert

.12 The AICPA publishes an Annual Reviewers' Alert each year that provides peer review team captains and firms with information highlighting significant matters in the profession, such as issues raised by the SEC and new accounting and auditing pronouncements. In the spring of 2001, the AICPA anticipates that this publication will be available online at www.aicpa.org. Team captains and the firm's quality control leaders should obtain and read this publication.

Summary

.13 This Alert summarizes some of the more significant common peer review recommendations. Every professional is advised to consider all of these issues when performing audits to help ensure that every audit is performed in compliance with generally accepted auditing standards.

[The next page is 51,011.]



Section 16,200

Practice Alert 01-2 **Audit Considerations in Times of** **Economic Uncertainty**

October, 2001

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing professional literature, the experience of the members of the Professional Issues Task Force (PITF) and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with the professional literature and that it is only a means of assisting auditors in meeting their professional responsibility.

Introduction

.01 During the past several months, the U.S. economy has suffered some significant declines. The U.S. Commerce Department has reported declines that are consistent with a slowing economy: consumer confidence has dropped, plant closings and lay-offs have increased dramatically, profit margins for many companies have slipped and many dot-com companies have failed. Some economists predict a recession, which could result in further deterioration in internally generated cash flows and restrictions on the availability of capital.

.02 Periods of economic uncertainty lead to challenging conditions for companies due to potential deterioration of operating results, increased external scrutiny, and reduced access to capital. These conditions can result in increased incentives for companies to adopt practices that may be incorrect or inconsistently applied in an effort to address perceived expectations of the capital markets, creditors or potential investors. During such times, professional skepticism should be heightened and the status quo should be challenged. This Practice Alert is designed to remind auditors of issues to consider during these times.

Professional Skepticism

.03 The third general auditing standard stipulates that due professional care be exercised in planning and conducting an audit engagement. Due professional care requires that the auditor exercise professional skepticism in gathering and evaluating audit evidence. Although the auditor neither assumes that management is dishonest nor assumes unquestioned honesty, the auditor should consider the increased risk associated with the potential increases in external pressure faced by management in times of economic decline.

.04 As a result of perceived external pressures, companies may be tempted to manage earnings through conduct of non-recurring transactions or through changes in the method of calculating key estimates, such as reserves, fair values or impairments. Companies may also adopt inappropriate accounting practices resulting in improper recognition or omission of financial transactions. Material non-recurring transactions may require special disclosure to facilitate the reader's understanding of the reported financial results, and the guidance in APB No. 20, *Accounting Changes*, should be applied in reporting on the effect of changes in estimates. Inappropriate transactions or accounting practices that may result in errors requiring adjustments of financial statements might include premature recognition of revenue, failure to record returns, inflating inventories, failure to appropriately accrue for contingent liabilities that are probable and estimable, and failure to record "misplaced" or otherwise unpaid purchase invoices. Additionally, an auditor should be particularly skeptical of non-system adjustments or fourth-quarter events that result in significant revenue recognition, loss accrual or non-cash earnings.

.05 The SEC has recently focused significant renewed attention with respect to potential inappropriate over-accrual or misuse of restructuring reserves. In this regard, auditors also have to be skeptical that provisions for restructuring costs and asset write-downs are not unduly conservative. Relevant accounting guidance can be found in SAB 100, *Restructuring and Impairment Charges*, and EITF Issue 94-3, *Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (Including Certain Costs Incurred in a Restructuring)*. Additionally, the increased focus of external analysts on revenue rather than traditional measures of operating performance has resulted in the SEC providing companies with expanded interpretive guidance in SAB 101, *Revenue Recognition in Financial Statements*, which addresses recognition and classification of revenue.

.06 The appropriate level of professional skepticism is needed when corroborating management's representations. Management's explanations should make business sense. Additionally, the auditor may need to consider corroborating management's explanations with other evidence when practicable, including discussions with members of the board of directors or audit committee.

.07 Other indicators of potential increased accounting and reporting risk calling for increased professional skepticism include:

1. Liquidity matters

- The company is undercapitalized and is relying heavily on bank loans and other credit and is in danger of violating loan covenants.
- The company appears to be dependent on an IPO for future funding.
- The company is having difficulty obtaining or maintaining financing.
- The company is showing liquidity problems.

2. Quality of earnings

- The company is changing significant accounting policies and assumptions to less conservative ones.
- The company is generating profits but not cash flow.

3. Industry characteristics

- The company is a dot-com or Internet company or a supplier to those types of companies.
- The company is not a market leader. Companies that are not market leaders sometimes must sell products below cost to match competitors' pricing.

4. Management characteristics

- Management's compensation is largely tied to earnings or the appreciation of stock options.
- The company appears vulnerable to the weakening economic conditions and management is not proactive in addressing changing conditions.
- The company's management is selling their investment in company securities more than in the past.
- There is a significant change in members of senior management or the board of directors.

.08 The following paragraphs serve as reminders for considerations when auditing the following specific accounts.

Inventory

.09 When auditing inventory, consider the following issues:

- The reason for an unusual increase in inventory balances. Reduction in turnover, increased backlog or deterioration in aging of inventories may be signs that the company has excessive inventory on hand.
- Whether the company's product is technologically attractive to consumers. If not, consider the company's plan to sell the inventory and at what cost.
- Whether declining prices and shrinking profit margins are causing inventory to be valued over market.
- Whether the reduced production at a manufacturing facility is leading to an over-capitalization of inventory overhead rather than expensing the costs of excess capacity.
- Whether there are material or unusual sales cancellations and returns after year-end.
- Whether there are indications of "channel stuffing."

.10 An auditor should also be aware of any:

- Unfavorable purchase commitments.
- Unfavorable sales commitments or arrangements.

Accounts Receivable

.11 When auditing accounts receivable, consider the following circumstances:

- An increase in the aging of receivable balances. This event may be indicative of weakening economic conditions. Many companies that sell to Internet-related companies may need to increase their bad debt provisions this year since some of these Internet-related companies are facing financial challenges that may include bankruptcy.
- Internal controls over credit functions are weak. Consider a company's policies for reviewing the amount of customer credit extended to each customer.
- Receivable amounts that are increasing at a faster rate than revenue.
- Concentration of receivables in one geographic area or economic sector.
- The existence of extended payment terms or return privileges.
- Significant decreases in accounts receivable confirmation response rates from the prior year.
- Compliance with revenue recognition pronouncements, such as SOP 97-2, *Software Revenue Recognition*, and SAB 101, *Revenue Recognition in Financial Statements*.

Investments

.12 An auditor should determine whether the classification of securities is appropriate. For example, an auditor should consider whether the company has the ability, as well as the intent, to hold securities to maturity that are classified as such.

Long-Lived Assets, Including Goodwill and Intangibles

.13 Industry downturns and cash flow erosion may indicate an impairment of fixed assets, goodwill or other intangibles. FASB 121, *Accounting for the Impairment of Long-Lived Assets to Be Disposed Of*, provides guidance in this area. In that regard, significant idle plant capacity or equipment no longer used in operations may need to be written off, unless alternative uses exist.

.14 Goodwill and intangibles should be analyzed to consider whether the amortization assumptions still appear reasonable. For example, if a company purchases a patent that is amortized over 10 years and the technology of the product has changed to where the patent is no longer used, it may be necessary to write-down or write-off the asset.

.15 In June 2001, the FASB issued Statement No. 142, *Goodwill and Other Intangibles*. This Statement addresses financial accounting and reporting for acquired goodwill and other intangible assets and supersedes APB Opinion No. 17, *Intangible Assets*. The Statement also addresses how intangible assets that are acquired individually or with a group of other assets should be accounted for in financial statements upon their acquisition. FASB Statement No. 142 is required to be applied starting with fiscal years beginning after December 15, 2001.

Deferred Taxes and Other Deferred Charges

.16 An auditor should consider whether the assumptions and expectations of future benefits of deferred tax assets and other deferred charges appear reasonable. In weighing positive and negative evidence for purposes of

assessing the need for or amount of a deferred tax asset valuation allowance, FASB 109, Accounting for Income Taxes, requires that the weight given to evidence be commensurate with the ability to objectively verify that evidence. As a result, recent historical losses are given significant weight while expectations about future profits may not be given much weight.

Accounts Payable

.17 An auditor should consider whether the company has delayed making payments on its outstanding payables. This may result from the company properly managing cash, but it may also be a result of a company experiencing cash flow shortages. An increasing accounts payable balance with flat or decreasing sales may be evidence of cash flow concerns.

Debt

.18 An auditor should carefully review loan agreements and test for compliance with loan covenants. In this regard, an auditor should consider any “cross default” provisions; that is, a violation of one loan covenant affecting other loan covenants. An auditor should also keep in mind that any debt with covenant violations that are not waived by the lender for a period of more than a year from the balance sheet date may need to be classified in the balance sheet as a current liability.

.19 As always, an auditor should 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 such 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 the previous year.

Going Concern

.20 During times of economic uncertainty, an auditor should have a heightened sense of awareness of a company’s ability to continue as a going concern. SAS 59, *An Entity’s Ability to Continue as a Going Concern*, addresses an auditor’s responsibility to evaluate whether there is substantial doubt about the entity’s ability to continue as a going concern. Negative trends, loan covenant violations and legal proceedings are examples of items that might indicate that there could be substantial doubt about the ability of an entity to continue as a going concern. When evaluating management’s plans to continue as a going concern, an appropriate level of professional skepticism is important. For example, the company’s assumptions to continue as a going concern should be scrutinized to assess whether they are based on overly optimistic or “once in a lifetime” occurrences.

Other Considerations

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- An auditor should consider the extent of procedures that may be necessary relating to unusual and significant transactions noted during the audit, including unusual or “non-routine” journal entries. Many times, these entries are made on the parent company’s books, or as part of a consolidating entry, or in the last few days of the month.

- An auditor should be aware of new developments in his or her client's business. Analytical reviews, therefore, should emphasize the comparison of relationships with independent data. When expected fluctuations do not occur, or when unexpected fluctuations do occur, an auditor should investigate the reasons. It is also important to consider whether the relationships between financial and nonfinancial information make sense. For example, in a cable TV company, if the number of subscribers declined from the prior year, it would make sense, absent a rate increase, that revenue declined also.
- An auditor should consider whether significant declines in stock prices may result in option pricing changes or other compensation benefits being promised to employees.
- An auditor should be aware of inconsistent approaches to write-downs.
- An auditor should consider off-balance sheet risks; for example, the risks related to the failure to perform a contract efficiently. Large fixed fee contracts can subject companies to large risks.
- An auditor should consider a company's ability to forecast and anticipate changes in market conditions. The inability to forecast and foresee changes in market conditions should heighten an auditor's professional skepticism. Companies that are proactive and lead market changes often perform better in times of economic uncertainty than those that are reactive.
- Professional skepticism relating to the above should also be maintained when reviewing quarterly financial statements for public companies.
- An auditor should not allow client or self-imposed deadlines to pressure him or her into accounting and auditing decisions that are not well thought out. An auditor should also consult with other professionals whenever appropriate—for example, on a complex accounting or auditing issue.

Summary

.22 Auditing companies in times of economic uncertainty is challenging. As such, auditors need to maintain the appropriate levels of professional skepticism and due professional care.

[The next page is 51,031.]

Section 16,210

Practice Alert 02-1

Communications With the Securities and Exchange Commission

February/March, 2002

NOTICE TO READERS

This Practice Alert is intended to provide auditors and SEC registrants with information that may help them improve the efficiency and effectiveness of their communications with the SEC and their audits and accounting and financial reporting processes, respectively. This Alert is based on existing professional literature, the experience of the members of the Professional Issues Task Force (PITF) and information provided by SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and is not an official position of the AICPA. Official positions are determined through certain specific committee procedures, due process and deliberation. The information provided herein should be used only with the understanding that it is to be read in conjunction with the professional literature and that it is only a means of assisting auditors in meeting their professional responsibility.

Introduction

.01 The purpose of this Practice Alert is to provide registrants and their auditors with the most up-to-date information about when, why and how they may wish to discuss SEC accounting, financial reporting and disclosure issues and questions with the staff at the Securities and Exchange Commission. In addition, this Alert is intended to provide professionals with references to other resources that may be useful when working with SEC registrants. While this information should assist auditors as they serve their clients, it is important to remember that registrants have the primary responsibility for the financial statements and related disclosures filed under the U.S. federal securities laws.

.02 In 1996, the SEC Regulations Committee of the AICPA (the "Regs Committee") worked with the SEC staff to develop and issue a document entitled "Communications with SEC Staff." The document summarized "best practices" for consultation among the registrant, the independent auditors and the SEC staff. The Regs Committee is part of the AICPA SEC Practice Section and acts as the primary liaison between the profession and the SEC on technical matters relating to SEC rules and regulations. The Regs Committee also responds to requests for comment on certain SEC proposals and communicates, through the minutes of its meetings located on the SEC Practice Section's Web site, important SEC developments to AICPA members.

.03 In 1999, the SEC staff in the Office of the Chief Accountant ("OCA") issued a "Protocol for Registrant Submissions to the Office of the Chief Accountant." That document was updated in December 2001 and retitled "Guidance for Consulting with the Office of the Chief Accountant" (the "OCA Protocol"). The OCA Protocol is available on the SEC's Web site at www.sec.gov/info/accountants/ocasubguidance.htm.

When to Contact the SEC

.04 Throughout the year as well as during the year-end audit, registrants and their auditors may encounter significant accounting, financial reporting, and disclosure questions, especially those involving unusual, complex, or innovative transactions for which no clear authoritative guidance exists. Registrants and their auditors are encouraged to discuss such issues with the SEC in advance of a filing. Additionally, registrants and their auditors are encouraged to discuss issues relating to specific requirements of various SEC filings in order to clarify the application of the requirements to certain registrant submissions.

Who Is Who at the SEC

.05 The Office of the Chief Accountant within the SEC is responsible for developing accounting and financial reporting policies (e.g., financial reporting releases, staff accounting bulletins, etc.). The OCA also has the final authority, subject to appeal to the Commission, on accounting issues in registrant filings that have been challenged by the Division of Corporation Finance (“DCF”).

.06 The DCF is responsible for reviewing and commenting on registration statements, proxy filings and periodic reports, such as Forms 10-K, 10-Q and 20-F.

.07 Different procedures may apply to communications with the SEC depending upon the nature of the issue and the SEC department responsible for handling such issue. In dealing with the OCA, formal procedures outlined in the OCA Protocol document should be followed. In dealing with the DCF, where a formal protocol is not available, the AICPA “best practices” document provides guidelines.

Communications With the OCA

.08 The OCA Protocol states that “the Commission encourages all those whose responsibility it is to report fairly and accurately on a company’s financial condition and results to seek out the staff’s assistance.” Sufficient advance notice is required so as to enable the appropriate SEC staff to be able to attend the meeting. Unless already provided in the submission to the OCA, a written submission of the subject issue should generally be provided at least five business days in advance of all meetings.

.09 The OCA staff prefers that questions be submitted in writing on a named basis. This type of correspondence is commonly referred to as a “pre-filing” submission. However, as discussed in more detail below, the staff will accept no-name and oral inquiries as time permits.

.10 The AICPA “best practices” document recommends that prior to the registrant and the auditor making a written submission to or discussing a matter with the SEC, the engagement partner discuss the matter with the concurring review partner and the firm’s designated SEC partner. The “best practices” document defined the term “SEC partner” as a partner who can represent the firm on accounting and auditing policy matters and state the firm’s position. At some firms, the designated SEC partner may be a member of the firm’s technical group located in a national or a regional office or may be a partner with significant experience with SEC rules and regulations who is appointed to represent the firm.

.11 New or controversial issues involving general accounting policies may be referred directly to the OCA. If the audit engagement partner is to discuss a significant issue with the OCA staff or the discussion involves the OCA or the DCF Chief Accountant's Office, it is recommended that the designated SEC partner also be involved in all such communications whenever possible. In addition, the "best practices" document suggests that any communications with respect to registrant accounting or reporting matters not be undertaken without the consent of the registrant. Further, there ought to be a clear understanding with the registrant that the process will be conducted with candor and all pertinent facts will be disclosed to the SEC staff.

.12 A written pre-filing submission to the OCA can be sent either by mail, fax or e-mail. The OCA recommends that submitters contact and advise the OCA that a pre-filing submission has or will be sent. The OCA's telephone number is (202) 942-4400. The submission should be addressed to:

Mr. Robert K. Herdman
Chief Accountant
Office of the Chief Accountant
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-1103
Fax: (202) 942-9656
E-mail: oca@sec.gov

A copy of each submission to the OCA and the accompanying materials should be mailed or faxed to the DCF at the following address:

Mr. Craig Olinger
Deputy Chief Accountant
Division of Corporation Finance
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549-0410
Fax: (202) 942-9582

.13 In all initial communications with the OCA, the inquiry should advise the OCA of any current or previous discussions or correspondence with the staffs from the Division of Enforcement, DCF, or other Divisions or Offices regarding the issue(s) in the submission.

.14 Subsequent to the submission, a confirmation of receipt of the submission can be obtained by contacting the OCA at (202) 942-4400.

.15 The OCA recommends that the submission be prepared in a format that provides (a) background information and all relevant facts, (b) the question being raised, (c) possible alternative answers, (d) the registrant's recommendation and basis for that recommendation, and (e) the financial statement impact, including the disclosures expected to accompany the accounting. The submission should include, at a minimum:

- The name of the registrant, the nature of its business and the name of the audit firm.
- Overview of the nature of the company's business, together with condensed financial information including assets, stockholders' equity, revenues, gross margin, pretax income and other relevant measures.
- Timing considerations, such as pending filing deadlines or registration efforts.

- Detailed information regarding the specific facts and circumstances giving rise to the accounting, financial reporting or auditing question.
- The specific accounting, financial reporting or auditing question raised.
- The accounting treatment proposed by the registrant and the basis for that conclusion, including an analysis of all the relevant accounting literature, as well as all alternatives considered and rejected.
- Analysis of the current and future financial statement impact of the alternatives considered.
- The proposed disclosure with respect to the accounting and where it will be disclosed.
- A statement regarding the conclusion of the auditor on the proposed accounting treatment.
- The name of the local audit partner and, if applicable, whether the submission and proposed accounting have been discussed with the auditor's national office and, if so, when this discussion occurred and the national office contact person. Additional contact persons may also be provided, such as representatives of the company's legal counsel.
- Whether the proposed accounting has been reviewed with the registrant's audit committee and that committee's views, if any, as to the proposed accounting.
- Whether the registrant or its auditors are aware of any prior SEC staff position related to the issue.
- Whether there have been any informal or formal conversations with any member of the SEC staff, including any current or previous discussions or correspondence with the Division of Enforcement, DCF, or other Divisions or Offices regarding the issues in the submission and the context of those discussions.
- The name and phone number of a contact person.

.16 The names and identities of those who will be participating in any follow-up discussion also should be furnished.

.17 The OCA suggests that the submission also include any relevant information that may assist the SEC staff in reaching a conclusion. Such information may include: organizational charts, relevant press releases, contracts or legal documents including portions that may be subject to differing interpretation, board of directors' minutes, and management information submitted or presented to the board or a committee of the board.

.18 Under OCA procedures, assigned OCA staff generally contacts the submitter, usually within three days of receiving the submission, with follow-up questions or to schedule a conference call involving the registrant and/or its auditors. Through this communication, the submitter becomes aware of the specific OCA staff members assigned to the issue and the OCA is able to determine whether the registrant has certain timing needs for resolving the issue. If the submitter desires an expedited response, it is recommended that the request for an expedited response be made with the initial submission; however, the submitter may make the request at any point during the process. Although it is not a SEC requirement, when the issue involves a registrant-specific

transaction, it is preferable for the registrant to lead the discussion (particularly with respect to representations as to the factual circumstances of an issue) with the independent auditor functioning in a support capacity by reinforcing and, where necessary, clarifying or expanding on the technical points made by the registrant.

.19 After the OCA staff completes its review of the subject issue, the staff provides an oral response to the registrant along with an explanation of the basis for the OCA's position. For the registrant's records, upon resolution of an issue, the registrant may prepare, and send to the OCA staff for their comment, a draft letter describing the registrant's understanding of the OCA staff's position. The final letter may be incorporated into the SEC's files to document the position taken by the staff with respect to the specific matter.

.20 Registrants and their auditors can also discuss issues with the OCA staff on either an oral (identifying the registrant) or "no name" (oral or written) basis. The OCA has provided a list of staff assignments for informal inquiries to the OCA at www.sec.gov/info/accountants/informalinq.htm.

.21 A "no-name" discussion is typically one where the auditors will call or write OCA on behalf of an individual registrant and pose a question without indicating the name of the registrant. An oral inquiry is less formal than the written submission but can be useful in assessing the OCA's position on various matters. This method of communication by the registrant and its auditors is especially helpful in inquiries that involve broader, emerging issues that are not registrant specific. However, such informal advice cannot be relied upon as authoritative and is not binding on the OCA staff. Any proposed written or oral communications with the OCA staff by auditors regarding staff "no name" inquiries on accounting and auditing matters or matters deemed policy in nature should be reviewed by the firm's designated SEC partner. Because of concerns that a clear understanding of the facts may not be accomplished through oral communications, the inquiry process would be best accomplished through written submissions on a named basis. Also, written submissions on a named basis take priority over "no-name" inquiries. If a written, no-name inquiry is received with detailed registrant and transaction specific facts and circumstances, the staff will request the name of the registrant. Submissions will be assigned to the appropriate OCA staff and are generally prioritized based on the date received.

.22 If there have been oral inquiries, the staff member that responded to the oral inquiry should be copied on any related subsequent written communication. For both written submissions and oral inquiries, the position of the staff may change in the event that new or additional facts arise.

Communications With the DCF

.23 All questions concerning the age, form and content of financial statements, required to be included in a filing, should be sent directly to the Chief Accountant of either the DCF, the Division of Investment Management or the Division of Market Regulation, as appropriate.

.24 With respect to DCF staff comments on specific filings, the DCF encourages the registrant and its auditors to communicate directly with DCF staff accountants in resolving the comments. If the registrant and its auditors do not understand a comment, the DCF staff accountant, who is identified in the comment letter, should be called to discuss the comment. This process may

be expedited by scheduling a conference call between the DCF staff, the registrant and its auditors to discuss certain comments. Comments cannot be cleared over the telephone; therefore, a written response should be provided to the DCF staff as a follow-up to any telephone discussion.

.25 During the course of its review of a registrant's periodic reports and registration statements, the DCF may conclude that the registrant's accounting does not comply with GAAP or the SEC's rules and that a restatement of the registrant's financial statements is necessary. DCF is not required by SEC policy to review its conclusions regarding registrant accounting issues with OCA, although it is not uncommon for accountants in DCF to discuss registrant specific issues with OCA prior to communicating its conclusions to a registrant. Registrants who desire to have a decision by the DCF reviewed by OCA should notify DCF and OCA at the earliest possible date so that the issue may be reviewed expeditiously and the filing may be processed in a timely manner.

Appeals

.26 The AICPA "best practices" document recommends that if a registrant wishes to appeal an accounting conclusion of a Senior Assistant Chief Accountant in DCF, the registrant is encouraged to consult with its audit engagement partner and the audit firm's designated SEC partner. After the registrant has requested an appeal, the Senior Assistant Chief Accountant will consult with an Associate Chief Accountant in the Division Chief Accountant's Office and generally will set up a conference call with all parties to discuss and resolve the issue. This process will be expedited if the registrant provides a detailed written response to the comment(s) prior to requesting an appeal. If the issue cannot be resolved at the Associate Chief Accountant level, it will be presented to the Division Chief Accountant's Office, and then to the Office of the Chief Accountant of the Commission. When communicating with staff at higher levels (e.g., Associate Chief Accountant, Deputy Chief Accountant or Chief Accountant of the DCF or the OCA), it is desirable to involve the audit firm's designated SEC partner along with the registrant and the engagement partner. Ultimately, it may be appropriate to request a meeting with the Chief Accountant.

.27 A decision of the Chief Accountant of the SEC may be appealed to the Commission.

Other Sources of Useful Information

.28 The Internet has provided registrants and auditors with access to a vast amount of information that may be useful when dealing with the SEC. In addition to the Web sites previously mentioned, the following may also be of interest:

- The AICPA at www.aicpa.org.
- Minutes of the Regs Committee at www.aicpa.org/belt/sec-hl.htm.
- The FASB at www.fasb.org.
- The SEC at www.sec.gov.

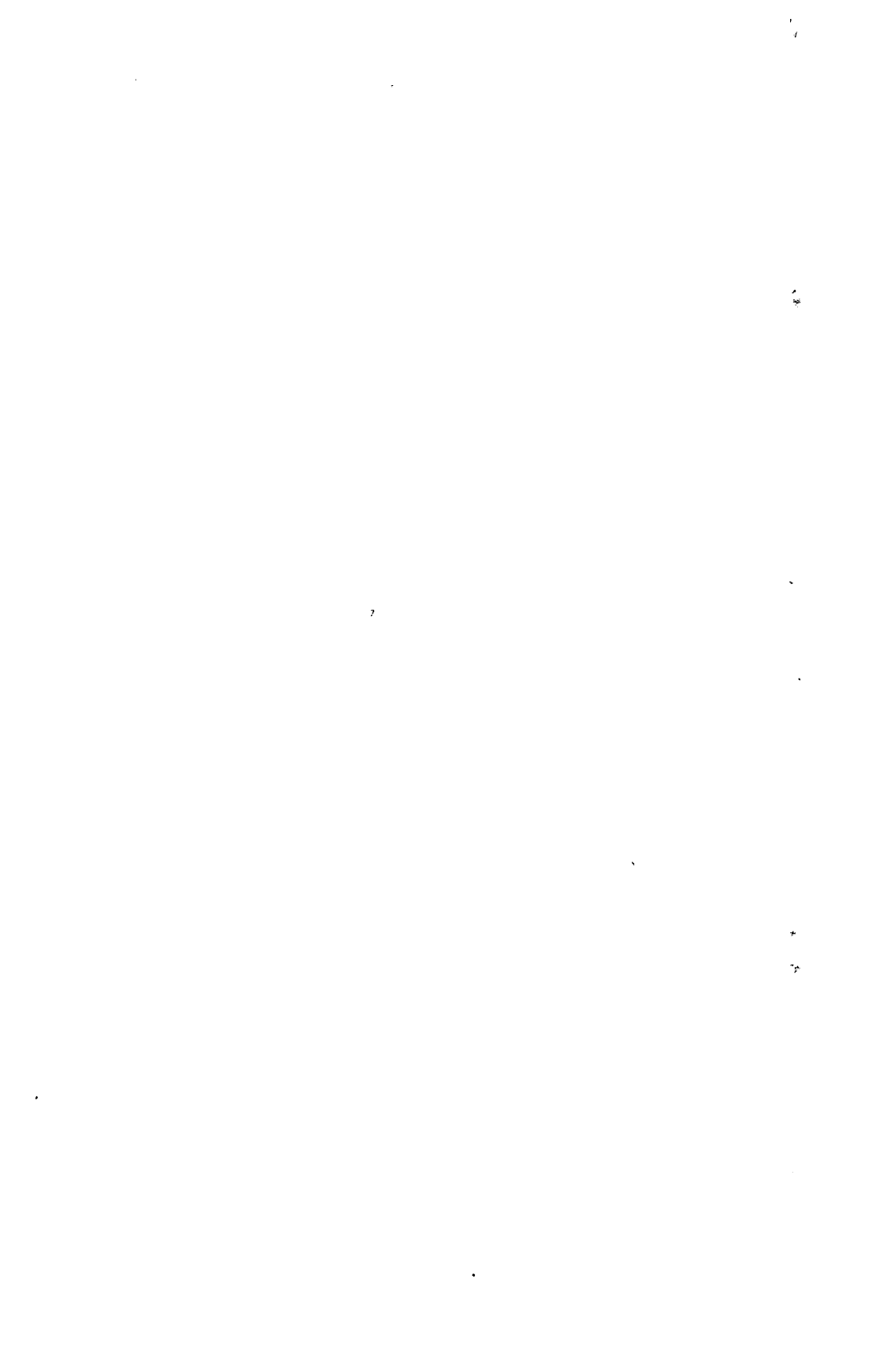
.29 Information to be found at the SEC's Web site includes the following:

- Recent Staff Accounting Bulletins at www.sec.gov/interps/account.shtml.
- Staff Legal Bulletins at www.sec.gov/interps/legal.shtml.

- Edgar filings at *www.sec.gov/edgar.shtml*.
- Frequently Requested Accounting and Financial Reporting Interpretations and Guidance issued by DCF at *www.sec.gov/divisions/corpfin/guidance/cfactfaq.htm*.
- Commission speeches and public statements at *www.sec.gov/news/speech.shtml*.
- Excerpts from speeches by the Staff of the Office of the Chief Accountant at *www.sec.gov/info/accountants/speechoutline.htm*.

.30 The SEC staff also has an internal document entitled “Division of Corporation Finance—Accounting Disclosure Rules and Practices—An Overview—Training Material” which is available from the SEC’s Public Reference Room and from most financial printers. That publication is intended for use as a training and review manual for the DCF staff. It is made available to the public for its general information but is not an official publication of the SEC nor is it updated or corrected with any regularity.

[The next page is 51,051.]



Section 16,220

Practice Alert 02-2 **Use of Specialists**

May, 2002

NOTICE TO READERS

This Practice Alert is intended to provide auditors with information that may help them improve the efficiency and effectiveness of their audits and is based on existing professional literature, the experience of members of the Professional Issues Task Force (PITF) and information provided by the SEC Practice Section member firms to their own professional staff. This information represents the views of the members of the PITF and has not been approved by any senior technical committee of the AICPA. The auditing portion of this publication is an *Other Auditing Publication* as defined in Statement on Auditing Standards (SAS) No. 95, *Generally Accepted Auditing Standards*. *Other Auditing Publications* have no authoritative status; however, they may help the auditor understand and apply SASs. 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. This publication was reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA, and is presumed to be appropriate.

Introduction

.01 During the performance of an audit engagement, the auditor may decide to use the work of a specialist. A specialist is a person with a special skill or knowledge in a particular field other than accounting or auditing. The specialist may be either engaged by the client or by the auditor, or employed by the audit firm or the client. Although the auditor is expected to be knowledgeable about business matters in general, the auditor is not expected to have or obtain the same level of understanding of a subject field as an expert in that particular field. Examples of areas where specialists are utilized in audit engagements include:

- Valuations of certain types of assets, for example: land and buildings, plant and machinery, works of art, minerals and precious stones.
- Valuations of businesses and derivatives.
- Information technology.
- Determination of quantities or physical condition of assets, for example: minerals stored in stockpiles, and underground mineral and petroleum reserves.
- Actuarial valuations.
- Measurement of work completed and to be completed on construction contracts in progress for the purpose of revenue recognition. For example, providing corroborating evidence on the progress and possible obstacles to completing a hydroelectric plant.

- Legal interpretations of contracts and agreements, statutes, and government and other regulations.
- Evaluation of significant issues relating to federal, state or local income and other tax matters.

.02 Auditors may encounter difficulty in determining the appropriate situations in which to utilize a specialist and, in those cases when a specialist is appropriately utilized, understanding the findings of the specialist. The current guidance when specialists are used is broad and focuses on the use of all kinds of specialists. The purpose of this Practice Alert is to assist auditors in understanding their responsibilities both with respect to the use of specialists that have been engaged or employed by the audit client and the use of specialists engaged or employed by the audit firm.

Decision to Use a Specialist

.03 The decision to obtain the assistance of a specialist is generally made in the planning stage of the audit engagement. The auditor should ascertain whether or not specialized knowledge will be needed in order to corroborate management's assertions with respect to amounts in the financial statements. The auditor should not accept an engagement when it is not possible to obtain an appropriate level of understanding of the subject matter, either directly or through the use of a specialist.

Use of a Specialist Engaged or Employed by the Audit Client

.04 With respect to specialists engaged or employed by the audit client, the auditor should consider the specialist's qualifications and experience in the planning stage of the engagement. SAS No. 73—*Using the Work of a Specialist* states that the auditor should consider the professional certification, license or other recognition of the competence of the specialist in his or her field, as appropriate. In addition, the reputation and standing of the specialist in the views of peers or others familiar with the specialist's capability or performance can assist the auditor in assessing the specialist's qualifications.

.05 After the auditor has become satisfied with the qualifications and experience of the specialist, the auditor should then obtain an understanding of the specialist's work. The auditor can obtain the understanding in many ways, including reading professional literature dealing with the subject specialty, discussing the subject with other auditors who have performed similar engagements in the same field, discussing the subject with the specialist or with other specialists and attending relevant seminars on the subject. The auditor should consider the following:

- The objectives and scope of the specialist's work;
- The specialist's relationship to the client;
- The specialist's methods and the assumptions used, including the comparability to those used in the preceding period and those used by similar specialists, if known;
- The specialist's compliance with the auditor's requirements;

- The appropriateness of using the specialist's work for the intended purpose; and
- The form and content of the specialist's findings.

.06 In those situations where the audit client has engaged the specialist, during the planning process the auditor performs the necessary procedures to ascertain the nature of the specialist's relationship to the audit client. The auditor should assess the risk that the specialist's objectivity may be impaired. A specialist that is engaged by the client need not be independent, only objective. If the auditor determines that the specialist's objectivity might be impaired, the auditor should either engage another specialist or should perform additional procedures with respect to some or all of the specialist's assumptions, methods or findings to determine whether the findings are not unreasonable.

.07 If the auditor concludes that he or she will use the findings of a specialist, consideration should be given to the need to communicate with the specialist to confirm the terms of the specialist's engagement and to cover such matters as:

- The objectives and scope of the specialist's work.
- Clarification of the specialist's relationship with the client.
- Information as to the assumptions and methods intended to be used by the specialist and, if appropriate, as to their consistency with those used in the prior period and compared to those used by other industry specialists.
- The specialist's compliance with the auditor's requirements.
- The appropriateness of using the specialist's work for the intended purpose.
- The form and content of the specialist's findings as well as a general outline as to the specific items the auditor expects the specialist will cover in the report.
- The auditor's intended use of the specialist's work.
- The identification of the data to be supplied by the client to the specialist, so that the auditor is aware of what needs to be subjected to audit testing.
- Any non-client data that the specialist intends to use.
- The extent of the specialist's access to appropriate records and files.
- Confidentiality of the client's information.
- Documentation or further information required supporting the auditor's procedures and report.

.08 The auditor should consider obtaining a confirmation directly from the specialist regarding the nature and scope of his/her engagement.

.09 The use of a specialist does not allow the auditor to delegate his or her audit responsibilities. Therefore, the auditor must be able to understand the methods and assumptions used by the specialist in order to fulfill his or her audit responsibilities.

.10 The reliability of the source data used by the specialist is significant to the accuracy of the specialist's findings and ultimately, the audited financial statements. Therefore, the auditor performs procedures to corroborate the data, both accounting and non-accounting, that the client provided to the specialist, taking into account the auditor's assessment of control risk. The auditor's procedures may include making inquiries of the specialist to determine whether the specialist is satisfied as to the accuracy of the source data, identifying and conducting appropriate tests and considering the reliability and relevance of the data provided by the client to the specialist. For example, for an actuarial computation with respect to a pension plan, the auditor may, on a test basis, compare the demographic information to the client's personnel files and the payroll information to the payroll ledgers. In addition, the auditor may analytically review the rate of return on the plan portfolio for reasonableness and may test the forecasted earnings stream and the cap rate used in the valuation.

.11 The auditor should evaluate whether the specialist's findings support the related assertions in the financial statements. Ordinarily, the auditor would use the work of the specialist unless the auditor concluded that the specialist's findings are unreasonable. For example, an actuary with respect to an automobile insurance company client may conclude that the loss reserves should decrease over the percentage used in the previous year. The finding may be deemed unreasonable if the auditor is aware that the experience in the subject state during that year was that losses had increased statewide. If the findings appear to be unreasonable, additional audit procedures may be necessary or the opinion of another specialist may be obtained. If the matter was not resolved to the auditor's satisfaction, the auditor would consider whether to qualify his or her report or disclaim an opinion because of a scope limitation.

.12 The auditor would ordinarily not mention the work or findings of a specialist when expressing an unqualified opinion on audited financial statements, except in very limited circumstances described in SAS No. 73.

.13 The auditor should consider incorporating a specific representation in the client representation letter if the audit client has engaged a specialist. An example representation is as follows:

We assume responsibility for the findings of specialists inevaluating the (describe assertion) and have adequately considered the qualifications of the specialists in determining the amounts and disclosures used in the financial statements and underlying accounting records. We did not give nor cause any instructions to be given to specialists with respect to the values or amounts derived in an attempt to bias their work, and we are not otherwise aware of any matters that have had an impact on the objectivity of the specialists.

Use of Specialists Engaged or Employed by the Audit Firm

.14 Except at the time of employment and as necessary to satisfy ongoing educational and licensing requirements, the auditor would not ordinarily need to check the qualifications of a specialist employed by the audit firm. In addition, the internal specialist is subject to the firm's requirements with respect to independence.

.15 The auditor will need to make a determination as to whether the specialist is part of the audit engagement team. If the specialist is effectively functioning as a member of the audit team, SAS No. 73 does not apply. SAS No. 22—*Planning and Supervision* will apply in that situation since the specialist requires the same supervision and review as any assistant. For example, if a specialist is used to perform procedures as part of the engagement team, such as performing computer assisted audit techniques, then SAS No. 22 applies. Specific guidance with respect to the use of information technology specialists is provided later in this Practice Alert. However, if the client engages the audit firm's actuarial department to perform procedures with respect to a pension plan, and the auditor subsequently utilized that work, the specialist is not a member of the engagement team and the auditor should follow the guidance as outlined in the previous section of this Practice Alert.

.16 Generally, using a specialist within the audit firm reduces audit risk, as the specialist should be familiar with the firm's professional policies. In addition, the other members of the audit team are generally familiar with the specialist's qualifications. Auditors employed by firms that make use of subsidiaries or affiliated organizations should take special care in assessing the internal specialist's familiarity with firm policies. Even though the specialist and the auditor may be part of the same "parent" firm, the specialist may not be familiar with the audit firm's policies.

.17 If the auditor has engaged an outside specialist, an understanding with the specialist about the engagement should be obtained. The auditor may want to document the understanding and the arrangements with the specialist in writing. All other procedures with respect to the methods and assumptions used by the specialist and the use of the specialist's findings are consistent with those utilized for specialists engaged or employed by the client.

Examples of Specific Types of Specialists to be Utilized

Information Technology ("IT") Specialists

.18 The use of IT specialists is a significant aspect of many audit engagements. The Public Oversight Board's Panel on Audit Effectiveness issued a report in August 2000 which called for more effective participation in audits by IT specialists. The IT specialist is usually employed or engaged by the audit firm and the use of IT specialists is covered by SAS No. 22 and SAS No. 94—*The Effect of Information Technology on the Auditor's Consideration of Internal Control in a Financial Statement Audit*.

.19 SAS No. 94 provides guidance to assist auditors in determining whether to use the work of an IT specialist. To determine whether an IT specialist is needed, it is recommended that the auditor consider the following factors:

- The complexity of the entity's systems and IT controls, and the manner in which they are used
- The significance of changes made to existing systems or the implementation of new systems
- The extent to which data is shared
- 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.

.20 The extent of involvement of an IT specialist will depend on the complexity of information technology used in critical transaction cycles, control risk assessments and the information technology skills available in the engagement team. The role of the IT specialist may be to assist the engagement team in the following areas:

- Performing a preliminary review of computer processing
- Designing and implementing tests of controls and substantive tests related to information technology systems, including the use of computer assisted audit techniques
- Interpreting the test results
- Drafting client communications, such as internal control and management letters.

.21 In addition, the IT specialist can assist the auditor in addressing many audit procedures. The IT specialist can examine the client's data files and information and detect and highlight transactions or patterns that show possible irregularities. Examples where an IT specialist may be used to assist the auditor are as follows:

- Ratio analysis
- Revenue and other cut-off testing
- Accounts receivable or payable aging
- Examination of purchase ledger transactions
- Summarizing payments by vendor or invoice numbers
- Testing for duplicate invoices
- Searching for payments to specific individuals
- Stratifying payments by size and extracting unusual ones
- Analyzing payroll data in the search for unusual payments
- Matching payments to payroll master files to test for correct rates and deductions.

.22 IT specialists can also perform digit analysis—the process of using mathematical formulas and probability equations to examine data sets for irregularities. Examples include number duplication, excessive round numbers and identification of identical or near-identical entries in data subsets.

.23 When an IT specialist is used, the auditor's responsibility for information technology aspects of an audit cannot be transferred to that specialist. The auditor is responsible for:

- Determining, in consultation with the IT specialist, the objectives of the review of computer processing and the procedures to be performed
- Participating appropriately in performing the work
- Reviewing the results of the specialist's work

- Evaluating the results of the review as it affects audit risk and strategy and modifying the audit procedures to be performed accordingly
- Ensuring that the workpapers adequately document all information technology aspects of the audit.

Business Valuation Specialists

.24 The FASB 141—*Business Combinations* and FASB 142—*Goodwill and Other Intangible Assets* valuations that are performed in connection with purchase price allocations after a business combination and the impairment test required thereafter generally should be performed by a specialist. Although the auditor may have sufficient expertise to review the valuation, it is advisable for auditors to consider utilizing a valuation specialist. This is particularly so when the transaction and valuation has a material impact on the company's financial statements. That specialist may be internal or external, as considered necessary. The auditor should perform procedures to evaluate whether the specialist's findings support the related assertions in the financial statements.

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Practice Alert 02-3 **Reauditing Financial Statements**

September, 2002

NOTICE TO READERS

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Introduction

.01 An auditor may be engaged to reaudit and report on financial statements that have been previously audited and reported on by another auditor (the predecessor auditor). The auditor conducting a reaudit engagement (defined in SAS No. 84, *Communications Between Predecessor and Successor Auditors*, as the successor auditor but hereinafter referred to as the reauditor) should not place reliance on the work of the predecessor auditor. Even when a reputable firm has already audited the financial statements, the reaudit work performed and the conclusions reached are solely the responsibility of the reauditor.

.02 There are two common circumstances under which a firm may be requested to perform a reaudit:

- The predecessor auditor is unwilling or unable to reissue its report for the intended purpose. For example, a company may plan to file a registration statement with the Securities and Exchange Commission (SEC) for an initial public offering and the predecessor auditor is unwilling to be associated with the financial statements of an SEC registrant or the predecessor auditor may not be independent under the independence rules applicable to SEC registrants or may no longer be in business.
- A company may wish to have another firm audit and report on its financial statements. Sometimes, the company or the underwriter with respect to an initial public offering may desire to have the current period and all prior periods audited by the same auditor, necessitating reaudits of prior periods.

.03 The reauditor should be aware of the audit guidance provided in paragraphs 14 through 20 of SAS No. 84. The purpose of this Practice Alert is to provide practitioners with additional factors to consider when performing a reaudit engagement.

Client/Engagement Acceptance Procedures and Considerations

.04 In determining whether to accept an engagement involving a reaudit for a new client, the reauditor should request permission from the prospective client to make inquiries of the predecessor auditor. Specific consent from the prospective client is required to make sure that confidential information is not disclosed inappropriately. The reauditor, in determining whether to accept the engagement, should perform the communications with the predecessor auditor as required in paragraphs 7 through 10 of SAS No. 84, including inquiries as to (a) information that might bear on the integrity of management; (b) any disagreements with management as to accounting principles, auditing procedures or other similarly significant matters; (c) communications to audit committees or others with equivalent authority and responsibility regarding fraud, illegal acts by clients, and internal control related matters, and; (d) the predecessor auditor's understanding as to the reasons for the change of auditors. The reauditor should indicate to the predecessor auditor that the purpose of the inquiries is to obtain information about whether to accept an engagement to perform a reaudit. In the absence of unusual circumstances, the predecessor auditor should respond promptly and fully, on the basis of known facts, to the reauditor's reasonable inquiries. If due to unusual circumstances, the predecessor auditor does not fully respond to the inquiries, the predecessor auditor should clearly state that the response is limited.

.05 In some situations, the predecessor auditor (a firm) might not be able to respond fully to the reauditor's inquiries, for example, when the predecessor firm no longer employs the predecessor audit engagement team. In such situations, the reauditor should make reasonable efforts to locate the predecessor audit engagement partner or other senior members of the engagement team and make appropriate inquiries. In some cases, another firm may employ the partner who had responsibility for the predecessor firm's engagement or other senior members of the engagement team. The firm that currently employs a member or members of the predecessor audit engagement team is not a "predecessor auditor" as defined in SAS No. 84. That firm, however, would normally be expected to facilitate inquiries to such individuals provided that specific authorization to respond is obtained by the reauditor from the prospective client in a form satisfactory to the firm and the individuals, and the reauditor and prospective client acknowledge, in a form satisfactory to the firm, that the firm is not placing itself in the position of a predecessor auditor. When such specific authorization and acknowledgement has been provided, a member or members of the predecessor audit engagement team ordinarily should, absent certain other circumstances that would limit their response, respond to the inquiries of the reauditor based on the full extent of the individuals' knowledge.

.06 The reauditor also should consider information pertaining to the integrity of management and any disagreements between management and the predecessor that may be obtained by performing the following procedures:

- Inquiring of bankers, lawyers, underwriters and others with knowledge of management.

- Reading the Form 8-K reporting the resignation or dismissal of the predecessor auditor and the predecessor auditor's response, if available.
- Reading the audit committee communications issued by the predecessor auditor.
- Reading the management representation letters including the summary of uncorrected financial statement misstatements.
- Reading the company's copies of correspondence with the predecessor auditor and regulators, if applicable.

.07 In circumstances where the predecessor auditor is unwilling or unable to reissue its report, the reauditor should consider the reasons and their implications, especially when the predecessor disagreed with management over accounting or auditing matters or restricts access to his or her audit documentation.

.08 In making a decision to perform a reaudit, the firm's client acceptance procedures should consider the following:

- The ability of the reauditor to perform his or her firm's normal client acceptance procedures. The firm should consider performing background checks of key executives. In addition, the firm should consider implementing additional procedures in accepting reaudit engagements, such as required consultation with and approval by, designated senior firm personnel prior to acceptance of the reaudit engagement. National and large regional firms should consider designating members of senior management or the firm's national technical group, or personnel of equivalent authority, for this purpose.
- Reading the previously issued financial statements on which the reaudit is to be performed. The reauditor should consider conducting interviews of executive management, including the CEO, the CFO, and the Audit Committee. Based on those discussions and from discussions with the predecessor auditors, the reauditor may be in a position to make a preliminary assessment about, among other matters, significant accounting policies, balances and transactions.
- The need for advising the client that since the reaudit is a new audit, the risk exists that material misstatements may be identified that were not identified by the predecessor auditor or that the reauditor's judgment regarding the appropriate application of generally accepted accounting principles or the materiality of previously identified misstatements may differ from that of the predecessor auditor.
- Whether the reaudit is being undertaken in connection with his or her current audit of a subsequent period (hereinafter referred to as a "current period audit"), as a separate engagement to be reported on before completing a current period audit, or as a one-time engagement. If the engagement is a one-time engagement, the potential reauditor should strongly consider the reasons that he or she is not performing the current period audit and may wish to consider not accepting the engagement on that basis.
- The ability to obtain third party confirmation or other primary audit evidence as of the balance sheet date(s) or the need to obtain confirmations as of a subsequent date and test the intervening transactions.
- The ability to obtain the necessary audit evidence, especially in significant areas, such as inventories, receivables and revenue.

- The predecessor auditor's representation regarding whether there have been any disagreements regarding accounting or other matters with management.
- Whether there has been a significant change in the top management team of the client and whether current management is willing, and has sufficient knowledge of the financial statements subject to the reaudit, to make all required management representations. The possible difficulties in obtaining the representation letter in these circumstances are discussed later in this Alert.
- Whether there have been significant changes in internal control subsequent to the reaudit period and whether an adequate understanding of internal control in operation during the reaudit period can be obtained to plan the reaudit.
- Whether sufficient audit evidence can be obtained in support of material financial statement assertions in situations where significant amounts of information are initiated, recorded, processed, or reported electronically, and no other documentation of those transactions is produced or maintained, other than through the IT system (e.g., a telecommunications company that uses IT to create a log of the services provided to its customers, initiate and process its billings for the services and automatically record such amounts in electronic accounting records that are part of the system used to produce the entity's financial statements).

Planning the Reaudit

.09 In a reaudit, the nature, timing and extent of the audit procedures performed and the conclusions reached in the reaudit are solely the responsibility of the reauditor. Notwithstanding the procedures performed by the predecessor auditor, the reauditor must perform an audit in accordance with generally accepted auditing standards (GAAS). Accordingly, the reauditor should not assume responsibility for the predecessor auditor's work or plan to divide responsibility with the predecessor auditor under SAS No. 1, section 543, *Part of Audit Performed by Other Independent Auditors*. The predecessor auditor is not a specialist as defined in SAS No. 73, *Using the Work of a Specialist*, or an internal auditor as defined in SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*.

.10 The reauditor should request that the client specifically authorize the predecessor auditor to allow access to the predecessor auditor's audit documentation for the period or periods under reaudit and the period prior to the reaudit period. The reauditor should consider the information obtained from inquiries of the predecessor auditor and review of the predecessor auditor's report and audit documentation in planning the reaudit. Ordinarily, the reauditor documents his or her review of the predecessor auditor's audit documentation and any information identified with continuing audit significance in the reaudit audit documentation. The reauditor should consider specifically examining the predecessor auditor's audit documentation with respect to the following:

- Understanding of internal controls and control risk assessments,
- The identification of internal control related matters noted in the audit, reportable conditions and material weaknesses,

- The identification of fraud risk factors and the results of audit procedures in response to specifically identified fraud risk factors,
- Understanding the company's business,
- Uncorrected financial statement misstatements,
- Other identified risks of material misstatement,
- And other audit documentation with respect to critical or significant accounting and audit areas.

.11 The extent, if any, to which the predecessor auditor permits access to his or her audit documentation is a matter of the predecessor auditor's judgment. However, it is customary for the predecessor auditor, absent any unusual circumstances such as impending, threatened, or potential litigation, disciplinary proceedings or non-payment of outstanding fees, to permit the reauditor to review the audit documentation, including documentation of planning, internal control, audit results, and other matters of continuing accounting and auditing significance.

.12 If possible, in order to maximize effectiveness and efficiency, the reaudit should be planned in conjunction with the current audit, if applicable, and the audit procedures for both should be coordinated.

Understanding the Client's Business

.13 As a result of inquiries of the predecessor auditor and review of the predecessor auditor's audit documentation, the reauditor may obtain significant information, including copies of audit documentation, related to understanding the entity's business that the reauditor may use in planning the reaudit. If the reauditor decides to utilize that information, he or she should corroborate the information through inquiries of management, inspection of key documents, and such other audit procedures as he or she considers necessary in the circumstances.

Understanding of Internal Control, Assessment of Control Risk and Tests of Controls

.14 The reauditor, as required by GAAS, should obtain an understanding of internal control for those periods on which the reauditor is asked to report. Information obtained from his or her review of the predecessor auditor's audit documentation may assist the reauditor in obtaining the required understanding and evaluating the design of relevant controls. The reauditor should perform procedures to corroborate the understanding and evaluation and determine whether key controls have been placed in operation. If the reauditor plans to assess control risk below the maximum, he or she should design and perform appropriate tests of controls to determine that relevant controls were operating effectively during the reaudit period. The reauditor may either test relevant controls in operation during the reaudit period or test relevant controls in operation currently, and perform a "rollback" of changes in the design of the internal controls to the prior periods.

.15 In instances where a "rollback" is not possible and control risk will be assessed at maximum, audit evidence should be obtained via substantive testing. However, the reauditor should consider whether it is possible to design

effective substantive tests that by themselves will provide sufficient evidence that financial statement assertions are not materially misstated in circumstances when a significant portion of the information supporting one or more financial statement assertions is electronically initiated, recorded, processed, or reported. Refer to paragraph 68 of SAS No. 55, *Consideration of Internal Control in a Financial Statement Audit*, as amended by SAS No. 78, for guidance.

Substantive Audit Procedures

.16 Some substantive testing, which may include analytical procedures and tests of details, is required for all material account balances and classes of transactions. In performing analytical procedures, the reauditor should develop his or her own expectations and use those expectations to determine matters requiring further investigation.

.17 The reauditor may consider the knowledge obtained from his or her review of the predecessor auditor's audit documentation and inquiries of the predecessor auditor to determine the nature, timing and extent of procedures to be applied in the circumstances and to assist in determining his or her expectations when performing analytical procedures.

Inventory

.18 Since the reauditor did not observe physical inventories in the prior years, the reauditor must be able to perform satisfactory alternative procedures if inventories are material, including a current physical observation and performing a "rollback" of amounts to prior periods. The reauditor also should perform tests of intervening transactions and analytical procedures. Refer to paragraph 20 of SAS No. 84 for guidance.

Confirmations With Third Parties

.19 The reauditor may consider responses to confirmation requests received by the predecessor auditor, provided the reauditor is able to obtain copies from the predecessor auditor. The responses may relate to, for example, cash, accounts receivable, debt and transactions with related parties. The reauditor should evaluate the process used by the predecessor auditor in controlling the confirmation process and in selecting the accounts/items for confirmation and the persons or entities for inquiry. The reauditor is responsible for conclusions as to the adequacy of the confirmation responses received by the predecessor auditor, including the number and quality of those replies, and for alternative procedures with respect to nonreplies. The reauditor should consider directly obtaining confirmation responses relating to significant matters.

.20 In those instances where the reauditor is not able to obtain copies of confirmation requests from the predecessor auditor or when the reauditor concludes that additional evidence is required, the reauditor should: 1) reconfirm the amounts/terms of balances and transactions as of the balance sheet date, or 2) confirm at a date subsequent to the period of the reaudit, in connection with a current audit or otherwise, and apply appropriate tests of intervening transactions. The reauditor may consider these procedures to be more effective than obtaining copies of the confirmation requests from the predecessor auditor. In addition, the reauditor should perform appropriate

subsequent events procedures (e.g., inspection of subsequent payments on accounts receivable), which may provide additional evidence concerning certain assertions.

.21 If the substance of an inquiry to lawyers relates to a significant matter, the reauditor should obtain responses directly.

Opening Balances and Consistency of Application of Accounting Principles

.22 The reauditor obtains audit evidence concerning the impact of the opening balances on the financial statements being reaudited and the consistency of application of accounting principles from a variety of procedures. The reauditor may be able to obtain some evidence regarding opening balances and consistency of accounting principles by reading the audited financial statements for the prior period and the predecessor auditor's report thereon, and making inquiry and reviewing the audit documentation of the predecessor auditor.

.23 In performing these procedures, the reauditor should consider the independence and professional reputation of the predecessor auditor, and whether there are factors that preclude obtaining any evidence from reading the audited financial statements for the prior period and the predecessor auditor's report or reviewing the predecessor auditor's audit documentation. In addition, if, for any reason, the reauditor is not permitted to review the audit documentation of the predecessor auditor, the reauditor will not be able to obtain any evidence from reading the audited financial statements for the prior period and the predecessor auditor's report. Accordingly, the reauditor should perform appropriate alternative procedures with respect to the opening balances as of the beginning of the reaudit period and with respect to the consistency of accounting principles.

.24 The audit procedures performed on the reaudit period transactions may provide some audit evidence about the opening balances. For example, audit evidence gathered during the reaudit may provide some assurance about the existence and valuation of receivables and inventory recorded at the beginning of the year. Regardless of the procedures performed, the nature, timing and extent of such procedures are solely the responsibility of the reauditor.

Uncorrected Financial Statement Misstatements

.25 The reauditor should evaluate the treatment and effects of uncorrected financial statement misstatements on both opening and closing balances of the period under reaudit. With respect to uncorrected misstatements that were identified by the predecessor auditor, the predecessor auditor and the reauditor may have different methods of evaluating uncorrected misstatements and may come to different conclusions with respect to their effects on the financial statements taken as a whole; accordingly, the reauditor cannot be held to any decisions of the entity and the predecessor auditor regarding the materiality of uncorrected misstatements or their disposition. In evaluating the effects of any uncorrected misstatements, irrespective of whether identified by the predecessor auditor or by the reauditor during the reaudit, including those that exist at the beginning and end of the period under reaudit, the reauditor alone is responsible for obtaining sufficient evidential matter to support his or her conclusion that the financial statements are free of material misstatement.

Representation Letters

.26 Practical difficulties may arise in obtaining a representation letter with respect to a reaudit engagement. In some situations, a different management team is in place currently than during the original audit period. Current management may believe that it bears no responsibility for financial statements developed by prior management and may resist a request for their signatures on the representation letter. This situation does not alleviate the need for obtaining an appropriately signed representation letter from current management for all periods being reported on.

.27 The reauditor is advised to discuss the requirement for a signed representation letter early in the process to make sure that appropriate officials are aware of their responsibility for the audited financial statements and the efforts they must undertake to be able to provide the representations to the reauditor. If the reauditor is unable to obtain the written representations that he or she deems necessary from current management for all periods being reported on, a scope limitation exists.

Reporting Implications

.28 The reauditor should not issue a report that reflects divided responsibility as described in SAS No. 1, section 543 unless in connection with the reaudit, the reauditor has informed the predecessor auditor that he or she will rely on, and where applicable, refer to, the predecessor auditor's report on certain subsidiaries or divisions.

.29 In some circumstances, the reauditor may not be able to complete a reaudit. For example, during a current period audit, the reauditor may conclude that controls are insufficient to allow the reauditor to rely on the types of procedures available to evaluate accounts such as inventory. If the reauditor is unable to obtain sufficient competent evidential matter to express an opinion on the financial statements, the reauditor qualifies the opinion or disclaims an opinion because of the inability to perform procedures the reauditor considers necessary in the circumstances. The SEC does not generally accept such reports. In such situations, the reauditor may elect to resign from the engagement.

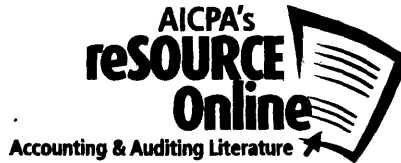
Other Audit Issues

.30 Because the reaudit report is dated as of the date that the reauditor completes fieldwork, subsequent events procedures are to be performed through that date. Subsequent events are disclosed in the reaudited financial statements if their disclosure is required to keep the financial statements from being misleading.

.31 The reauditor's consideration of the entity's ability to continue as a going concern for a reasonable period of time takes into consideration the reauditor's knowledge of relevant conditions and events that exist or have occurred prior to completion of the reaudit fieldwork. The reauditor should consider whether the financial statements adequately disclose such conditions and events, other conditions and events occurring subsequent to the balance sheet date, their possible effects, and any mitigating factors, including management's plans. If the reauditor concludes that substantial doubt remains about the entity's ability to continue as a going concern, the audit report should include an explanatory paragraph reflecting that conclusion.

Internal Inspection

.32 It is important that a firm monitor its reaudits to determine whether the engagements are being performed in accordance with generally accepted auditing standards and the firm's system of quality controls. Accordingly, a firm's internal inspection program should consider addressing the firm's re-audit engagements, including engagement acceptance procedures.



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